In re Pillowtex, Inc., 349 F.3d 711 (3d Cir. 2003), and disagreed with the Second and Ninth Circuits. App. at 12 (citing *In re PCH Associates*, 804 F.2d 193 (2d Cir. 1993), and *In re Moreggia & Sons, Inc.*, 852 F.2d 1179 (9th Cir. 1988)).

The court, however, ultimately paid only lip service to *Butner* and disregarded governing California law that forbids recharacterization of agreements in the form of a lease absent clear and convincing evidence of the parties' contrary intent. The court reasoned that "[b]urdens of proof and persuasion are supplied by the forum, not by the source of substantive law." App. at 13. This directly contradicts *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15, 20-21 (2000) ("we have long held the burden of proof to be a 'substantive' aspect of a claim" established by the source of substantive law that provides the rule of decision).

The court also held that the Bankruptcy Code preempted California's statute of limitations for challenges to government contracts like the Facilities Lease (which had expired long before United filed its bankruptcy case), concluding that "[s]tate procedures do not matter in bankruptcy." App. at 17. This contravenes both *Butner*, which requires that state law be applied, and *Guaranty Trust Co. v. York*, 326 U.S. 99 (1945), which holds that state statutes of limitation are part of the substantive law to be applied whenever state law provides the rule of decision.

Finally, the court altogether ignored the contrary Eleventh Circuit decision of *In re Martin Brothers Toolmakers, Inc.*, 796 F.2d 1435 (11th Cir. 1986), which rejected a challenge very similar to that made by United in

this case. In direct contrast to the opinion below, the Eleventh Circuit holds that transactions consummated with the purpose of improving public property (like the San Francisco airport) and enhancing the public welfare (as every transaction involving the Authority must) are not susceptible to judicial second guessing like that sanctioned by the court of appeals here.

* * *

The court of appeals' decision has far-reaching ramifications. It improperly extends federal law into areas that this Court has said are specifically governed by state law, namely the burden of proof for and statute of limitations on claims where state law provides the rule of decision. The decision broadly affects the application of the laws of all states applied in bankruptcy and other areas where federal courts are required to respect state law, and it creates the untenable situation in which federal courts and state courts purportedly applying the same state-law rule of decision will reach different results.

The decision also has broad implications for the public finance markets, potentially impacting billions of dollars of bonds and extending far beyond the parties to this litigation. Although the immediate concern to the parties is that United is now able to remain in possession of leased airport property without paying rent, the decision means that United may reap a similar windfall with respect to its other leases that back hundreds of millions of dollars of government bonds. Indeed, the same panel that decided this case already has nullified a United lease at John F. Kennedy airport in New York, and cases involving leases at the Los Angeles and Denver International Airports are now pending before that panel. More broadly, the

court has thrown into question the validity of all public bonds issued with lease revenue structures, thereby jeopardizing a time-honored method of financing improvements of all sorts of public property.

The court of appeals' disregard of this Court's precedents requiring the application of state law, the clear conflicts among the circuits, and the far-reaching implications of the decision all strongly suggest that review by this Court is necessary and appropriate.

REASONS FOR GRANTING THE WRIT

There are three primary reasons to grant this Petition. The first is to enable the Court to resolve an important question of bankruptcy law that results in a different answer (and a different justification for the answer) nearly every time it is confronted by a lower court. In this case, the court of appeals took it upon itself to rewrite and recharacterize a contract in a manner that conflicts with the original intent of the sophisticated contracting parties. By so doing, it not only created a new legal test – one neither briefed nor argued by the parties – it established an entirely new property right by which a debtor may occupy property without being either an owner or a tenant. The court's new doctrine adds to a string of conflicting, confusing opinions (both at the circuit level and lower) regarding the seemingly straightforward question of which types of agreements are to be enforced as "leases" in a bankruptcy case and which law is to be applied to answer that question.

The second reason for granting the writ is to correct the court of appeals' manifest disregard of state law in

violation of the clear mandates of this Court. The court's sweeping pronouncements that "[b]urdens of proof and persuasion are supplied by the forum, not by the source of substantive law," and that "[s]tate procedures do not matter in bankruptcy," are directly at odds with the decisions of this Court. The court's error in this regard was outcome determinative, as it resulted in a purported application of "state law" (as required by *Butner*) that rejected fundamental, substantive components of the California rule of decision. The district court in fact held in favor of the petitioners precisely because United had failed to satisfy its state-law burden of clear and convincing proof.

The final reason for granting this Petition relates to the vast implications of the court's *de facto* nullification of a widely-employed method of financing renovations to airports and other essential public properties. The court's decision severely and negatively impacts billions of dollars of airport lease revenue bonds outstanding in the capital markets, and is likely to make it more expensive and difficult to build and improve airports and a wide range of other public facilities.

I. The Opinion Below Adds Confusion To An Already Conflicting And Incoherent Body Of Circuit-Level Precedent Regarding An Important And Recurring Question Of Bankruptcy Law.

This case involves the meaning of the term "lease of nonresidential real property." Section 365(d)(3) of the Bankruptcy Code provides, in relevant part, that a trustee (or, in a chapter 11 reorganization like this case, the debtor in possession) "shall timely perform all the obligations of the debtor . . . arising from and after the order for

relief under any unexpired lease of nonresidential real property." 11 U.S.C. § 365(d)(3). In contrast, the Code generally does not require a debtor to perform under other pre-bankruptcy contracts that govern a debtor's interests in property (like a mortgage).[3]

The Code states that "leases of real property shall include any rental agreement to use real property," 11 U.S.C. § 365(m), but does not further define the term. Accordingly, the statutory language must be read consistently with its plain meaning. *E.g.*, *United States v. Ron Pair Enterprises*, 489 U.S. 235, 241 (1989) (in bankruptcy, "where, as here, the statute's language is plain, the sole function of the courts is to enforce it according to its terms") (quotation omitted).

A "lease" is commonly defined as "a contract granting the use or occupation of property during a specified period in exchange for a specified rent." AMERICAN HERITAGE DICTIONARY (2d ed. 1985) at 721. There is no question that the Facilities Lease fits squarely within that definition – it grants United the right to possess the maintenance facility for a term of forty years in exchange for the payment of a specified rent. If United fails to pay that rent, it may be evicted and the property may be re-leased to another.

[3] This is part of bankruptcy's set of trade-offs for landlords. On one hand, a landlord is entitled to ongoing payment of rent during the case (at least until rejection of the lease). On the other hand, the debtor is authorized to reject the lease and have the landlord's claim for damages converted into a general unsecured claim and capped at a maximum of one year's rent or 15% of the total remaining rent under the lease. 11 U.S.C. §§ 365(g), 502(b)(6), 502(g). In comparison, the holder of a mortgage is not automatically entitled to current payment, but is entitled to recovery of the full value of its interest in the debtor's property. 11 U.S.C. § 506.

The court of appeals deviated from the plain language approach and concluded that the term "lease" as used in the statute is merely a meaningless label. App. at 6 ("'lease' is a label rather than a form"). The court concluded that the Bankruptcy Code honors only what it called "true leases," and it thus moved beyond the language of the statute (and the agreement negotiated by the parties) to a determination of whether the Facilities Lease "functioned" more like a "true lease" or a mortgage. App. at 8.

In the process, the court of appeals minted a brand new doctrine. It concluded, without argument from the parties or citation to relevant precedent, that an inquiry into whether or not an agreement is a "true lease" depended upon what the court deemed to be the Bankruptcy Code's "system of separating financial from economic distress." App. at 11. The court held that bankruptcy relief is available to a debtor in "financial" distress by enabling the "write down" of a debtor's pre-bankruptcy obligations, but only when the debtor is not in "economic" distress and is able to pay its bills on an ongoing basis. App. at 6-8. The court concluded that a "true lease" is one that "pay[s] for new inputs" by giving the debtor the right to occupy property it otherwise would not be able to occupy. App. at 7. In contrast, the court held that a lease with rent "that represents the cost of funds for capital assets for past production or past operations rather than ongoing inputs into production has the quality of debt" and therefore is not a "true lease" under which a debtor must continue to pay rent. App. at 7. Applying this new "economic" analysis, the court concluded that the Facilities Lease did not qualify as a "true lease" under its financial/economic distress rubric because, in the lease-sublease transaction,

United had used its leasehold interest in the maintenance facility "to secure an extension of credit" and, as a result, the Facilities Lease rent did not qualify as payment for "new inputs." App. at 16.

The court of appeals committed numerous errors. First, a financial/economic distress dichotomy is not a touchstone for a "true lease." The text of the Bankruptcy Code makes no reference to or distinction between "financial distress" and "economic distress" nor, to the petitioners' knowledge, does any reported decision. This Court, on the other hand, has made it abundantly clear that the "[u]niform treatment of property interests by both state and federal courts within a State" is of paramount importance. *Butner*, 440 U.S. at 55 (quotation omitted). The court of appeals violated this fundamental rule by applying its new, anti-textual analysis to sweep aside property interests that, as explained in Section II below, clearly would be enforceable by the petitioners under state law. The court's decision is all the more pernicious as a result of the distinguished panel that issued it, providing, as it were, an economic rationalization for future courts to ignore the dictates of a state's real property law with which they do not agree.

This false dichotomy resulted in the first decision to "recharacterize" a lease in bankruptcy in the absence of any claim of ownership in the subject property by the debtor. All of the cases cited by United below involved "leases" that provided the debtor-"lessee" with an option to purchase "leased" property for a nominal amount, or that had a lease term that extended for the total useful life of the property. Those agreements, while in the form of a lease, were held to represent transactions in which the debtor in substance owned or would entirely consume the

property.[3] Until the court of appeals' decision in this case, courts enforced leases absent such a determination that the debtor actually owned the "leased" property. This makes sense because debtors, like others, can occupy property in only one of two ways – they can own it or rent it. Under the court of appeals' new doctrine, debtors like United may stay in possession of property that they do not own or lease, without paying anything for the privilege. This is as unprecedented as it is unfair.[4]

More importantly for purposes of this Petition is the fact that other courts have looked at this issue in completely different ways, reaching different conclusions with different rationales. The Ninth Circuit, for example, holds that state law is irrelevant to the question of whether an

[3] *See, e.g., In re PCH Associates*, 804 F.2d 193 (2d Cir. 1986) ("lease" that separated a hotel from the underlying land on which it was built, with a total term of 165 years (more than the useful life of the leased structure)); *International Trade Administration v. Rensselaer Polytechnic Institute*, 936 F.2d 744 (2d Cir. 1991) ("lease" with a 99-year term, with all "rent" paid in the first 3 years); *In re Moreggia & Sons, Inc.*, 852 F.2d 1179 (9th Cir. 1988) ("lease" where all rent was prepaid with a thirty-year term remaining and with no remaining rights to evict and re-let).

[4] The legislative history of the Bankruptcy Code confirms that ownership is a key consideration in the lease/financing analysis. The legislative history states that the statutory term "lease of real property" is to apply "only to a 'true' or 'bona fide' lease and . . . not . . . to financing leases of real property." S. Rep. 95-989 (1978), at 64. It goes on to state, however, that "lease financing" transactions are those "where, in substance, the 'lease' involves a sale of the real estate and the rental payments are in substance the payment of principal and interest on a secured loan or sale." *Id.* Congress used the term "financing lease" (which never appears in the text of the Bankruptcy Code itself) as the common shorthand description of a transaction in which the "lessee" finances its purchase of the "leased" property, *not* as a description of every lease executed as part of a financing transaction.

agreement is a lease for purposes of the Bankruptcy Code, and that the key question is whether the parties intended to create an "ordinary landlord/tenant relationship." *Moreggia*, 852 F.2d at 1182-86. The Second Circuit appears to apply an amalgam of state and federal law in an effort to answer the ultimate question of whether the "economic substance" of the transaction is that of a "true lease." *PCH Associates*, 804 F.2d at 196-201. The Third Circuit holds that state law governs exclusively. *In re Pillowtex, Inc.*, 349 F.3d 711, 716 (3d Cir. 2003).

The Eleventh Circuit, meanwhile, completely rejects the notion that a court can cast aside the form of agreement negotiated by a governmental entity, at least where the transaction at issue was not consummated solely for the benefit of private parties but instead in furtherance of broader interests like the improvement of public property. The Eleventh Circuit holds that "[t]he application of bankruptcy principles in this context would be particularly inappropriate, because such principles are developed in the context of only two competing private interests, and in this case we have a third, public, interest." *Martin Brothers*, 796 F.2d at 1440.

Moreover, the Seventh Circuit is now in conflict with itself as a result of the court's opinion in this case. In *In re Kassuba*, 562 F.2d 511 (7th Cir. 1977), a case not cited in the decision below, the Seventh Circuit rejected an "economic substance" analysis in favor of an inquiry based upon the intent of the parties, concluding that the lease portion of a sale-leaseback transaction was a "true lease" for bankruptcy purposes: "[T]he parties by contract may create a set of mutual economic benefits that is similar to a mortgage without conferring on each other the rights and liabilities of judicial foreclosure, if that is what they

actually intend. The substance of the transaction that a court of equity will examine is not its economic effect, which the parties determine by their agreement, but instead it is what their agreement is." *Id.* at 514.[5]

Finally, when this Court last addressed the "true lease" issue (in the tax context), it applied an analysis completely at odds with the decision below:

> [W]e hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, *the Government should honor the allocation of rights and duties effectuated by the parties*.

Frank Lyon Co. v. U.S., 435 U.S. 561, 583-84 (1978) (emphasis added).

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[5] The lower courts are in similar disarray. *Compare In re Omne Partners II*, 67 B.R. 793 (Bankr. D.N.H. 1986) ("bankruptcy judges [do not] have a warrant from Congress to run roughshod over the economic landscape recharacterizing commercial transactions entered into by sophisticated parties – restating them in terms of their 'economic substance' contrary to their negotiated and agreed form – in the absence of some triggering factor permitting such recharacterization"); *with In re Petroleum Prods.*, 72 B.R. 739 (Bankr. D. Kan. 1987) (following state law to hold that agreement is a lease even though, in court's view, the "economic realities" of the agreement were that of a mortgage); *with In re Barney's, Inc.*, 206 B.R. 328 (Bankr. S.D.N.Y. 1997) (it is not appropriate to recharacterize a lease without consideration of extrinsic evidence); *with In re Hotel Syracuse, Inc.*, 155 B.R. 824 (Bankr. N.D.N.Y. 1993) (refusing to follow state law and concluding, from the face of the documents, that an agreement was not a lease).

Thus, the courts have created conflicting rules to apply when a debtor files for bankruptcy and claims that an agreement it signed before bankruptcy is not enforceable as a lease even though it is called a lease, is in the form of a lease, and has the normal attributes of a lease. The outcome of any such challenge is likely to turn not on established state law property rights (as it should) but instead on the location of the bankruptcy court (or even the predilections of the bankruptcy judge).

This arbitrariness is contrary to the uniform application of state law mandated by the Court in *Butner*:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, discourage forum shopping, and to prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy.

Butner, 440 U.S. at 55 (quotation omitted). As things now stand, there is no "uniform treatment" of leases among the circuits. This results in precisely that which *Butner* condemned: it fosters uncertainty, encourages forum shopping, and enables debtors like United to receive a windfall "merely by reason of the happenstance of bankruptcy."

The Court should clarify and resolve this important issue.

II. The Court's Failure To Apply The State Burden Of Proof And Statute Of Limitations Contravenes *Butner v. United States*, *Raleigh v. Illinois Department Of Revenue*, And *Guaranty Trust Co. v. York*.

As noted above, this Court long ago established that, in bankruptcy, "property interests are created and defined by state law." *Butner*, 440 U.S. at 55; *accord, e.g.*, *Barnhill v. Johnson*, 503 U.S. 393, 398 (1992).

The court of appeals noted the Bankruptcy Code's silence as to the definition of a lease and correctly held that state law governs the question of whether or not an agreement is a "true lease": "Leases are state-law instruments, after all, and the norm in bankruptcy law is that *contracts (of which leases are a species) and property rights in general have the same force they would have in state court, unless the Code overrides the state entitlement*." App. at 11 (emphasis added). Thus, it held that California law, which the parties chose in the Facilities Lease to apply, provided the rule of decision. Instead of applying California law, however, the court then proceeded to replace the California rule with its own interpretation of federal law based upon its unique theory of the economics of a "true lease." While interesting, this economic analysis has no bearing on governing California law and, under *Butner*, has no proper place in the analysis.

The State Burden of Proof. First, the court refused to enforce California's burden of proof. The rule in California is unambiguous: a debtor has the burden of proving, by clear and convincing evidence, that an agreement in the form of a lease is actually a mortgage or financing device. As the California Supreme Court held in a "sale-leaseback"

case cited and discussed at length (in other respects) by the court of appeals:

> It is without doubt the law, as repeatedly declared in our decisions, that clear and convincing evidence is required to justify a court in finding that a deed which purports to convey land absolutely in fee simple was intended to be a mortgage. That a deed purporting on its face to convey the title absolutely may be shown by parol evidence to be something else – namely, a mortgage – is a striking exception to the general rule, and it has been universally held that *the character of the instrument cannot thus be changed except upon clear and convincing evidence.*

Beeler v. American Trust Co., 24 Cal. 2d 1, 7 (1944) (emphasis added) (quotation omitted).

The court of appeals purported to wipe away this established rule in two sentences: "Burdens of proof and persuasion are supplied by the forum, not by the source of substantive law. Bankruptcy law uses the preponderance standard. *Grogan v. Garner*, 498 U.S. 279 (1991)." App. at 13. Neither is correct.

In *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15 (2000), the Court held that, when state law provides the rule of decision in a bankruptcy case, as it does here, the bankruptcy court must follow and apply the state burden of proof associated with the state law rule. *Raleigh* involved whether a bankruptcy court had to apply the burden of proof otherwise applicable to Illinois tax claims. The debtor asserted that the taxing authority bore the ultimate burden of proof. The taxing authority asserted

that, under state law, the burden was on the debtor and should continue to apply in a bankruptcy case.

The Court first reiterated the basic principles of *Butner*:

> The "basic federal rule" in bankruptcy is that state law governs the substance of claims, *Butner, supra*, at 57, Congress having "generally left the determination of property rights in the assets of a bankrupt's estate to state law." 440 U.S. at 54 (footnote omitted). "Unless some federal interest requires a different result, there is no reason why [the state] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Id.* at 55.

Raleigh, 530 U.S. at 20. The Court concluded that those principles required the bankruptcy court to apply the burden of proof that would have been applied had the claim been litigated in state court:

> The scope of the obligation is the issue here. Do the State's right and the taxpayer's obligation include the burden of proof? Our cases point to an affirmative answer. *Given its importance to the outcome of cases, we have long held the burden of proof to be a "substantive" aspect of a claim.* That is, the burden of proof is an essential element of the claim itself; one who asserts a claim is entitled to the burden of proof that normally comes with it.

Id. at 20-21 (emphasis added) (citations omitted).

Similarly, *Grogan v. Garner*, cited by the court of appeals for the proposition that "[b]ankruptcy law uses the preponderance standard," App. at 13, demonstrates the court's error. *Grogan* involved a question of whether a

particular debt could be discharged under the Bankruptcy Code – an issue as to which the Code itself, and not state law, provided the rule of decision. *Grogan*, 498 U.S. at 283 ("the issue of nondischargeability has been a matter of federal law governed by the terms of the Bankruptcy Code"). Because the Code is silent as to the burden of proof, the Court held that the default civil litigation "preponderance of the evidence" standard applied. *Id.* at 286-90. The Court never held that all questions in bankruptcy are governed by a preponderance standard, or that the burden of proof somehow always lies with the nondebtor party. To the contrary, in a precursor to *Raleigh*, the Court expressly observed that "[t]he validity of a creditor's claim is determined by rules of state law." *Id.* at 283.

Thus, unlike the court of appeals' erroneous refusal to apply state law in this case, bankruptcy courts regularly apply clear and convincing standards of proof when applicable state or other nonbankruptcy law requires it, which can occur under all states' laws in a variety of substantive areas affecting property rights that may be at issue in a bankruptcy case.[6] This is consistent with the general rule in the federal courts under Rule 302 of the Federal Rules of Evidence, which provides that state law presumptions apply when state law supplies the rule of decision.

[6] *See, e.g.*, *In re Ellis*, 324 B.R. 595 (Bankr. M.D. La. 2005) (applying state law clear and convincing evidence standard regarding reformation of a mortgage due to alleged mutual mistake); *In re Davenport*, 268 B.R. 159 (Bankr. N.D. Ill. 2001) (applying state law clear and convincing evidence standard regarding establishment of resulting trust); *In re Todd*, 70 B.R. 204 (Bankr. N.D. Iowa 1986) (applying state law clear and convincing evidence standard regarding correction of mortgage amount).

The court of appeals' error in disregarding this Court's holdings and relieving United from its "clear and convincing" burden was outcome determinative. United submitted no evidence below. It simply relied on the terms of the documents. The district court held that this was not a sufficient showing by United to satisfy its burden under California law. The petitioners would have prevailed had the court merely respected the applicable state law rule as required by this Court's decisions.

The State Statute of Limitations. The court of appeals committed another outcome-determinative error when it held that California's statute of limitations for challenges to government contracts like the Facilities Lease was unenforceable in bankruptcy.

California has a statutory system that provides for parties who seek to challenge the validity or enforceability of a government contract to do so within sixty days after publication of required notices relating to the contract. *See* Cal. Civ. P. Code §§ 860-869. No such challenge may be made after expiration of that period. *Id.* § 869.

This statutory system is a statute of limitations. *Friedland v. City of Long Beach*, 73 Cal. Rptr. 2d 427, 434 (Cal. Ct. App. 1998). It applies to contracts, like United's Facilities Lease with the Authority, that are integrated components of a municipal bond issuance. *Id.* at 433-43. Because no timely challenge was made to the Facilities Lease, United's belated, post-bankruptcy action to contest the nature of the Facilities Lease was barred as a matter of California law.

The court of appeals, however, refused to recognize the California statute of limitations, holding, without citation or analysis, that "[s]tate procedures do not matter in

bankruptcy." App. at 17. This is demonstrably false. In *Guaranty Trust Co. v. York*, 326 U.S. 99 (1945), the Court long ago held that state statutes of limitations are a substantive component of state law and must be applied by federal courts in cases where state law provides the rule of decision. The Court framed the question as follows:

> And so the question is not whether a statute of limitations is deemed a matter of "procedure" in some sense. The question is whether such a statute concerns merely the manner and the means by which a right to recover, as recognized by the State, is enforced, or whether such statutory limitation is a matter of substance in the aspect that alone is relevant to our problem, namely, *does it significantly affect the result of a litigation for a federal court to disregard a law of a State that would be controlling in an action upon the same claim by the same parties in a State court?*

Id. at 109 (emphasis added). The Court answered affirmatively:

> Plainly enough, *a statute that would completely bar recovery in a suit if brought in a State court bears on a State-created right vitally and not merely formally or negligibly*. As to consequences that so intimately affect recovery or non-recovery a federal court in a diversity case should follow State law. . . . *[I]f a plea of the statute of limitations would bar recovery in a State court, a federal court ought not to afford recovery.*

Id. at 110 (emphasis added) (citation omitted). The Court reaffirmed the vitality of this venerable rule as recently as two years ago. *Jinks v. Richland County*, 538 U.S. 456, 465 (2003).

The rule is as true in bankruptcy as it is in diversity cases. In the Bankruptcy Code, Congress expressly chose to extend statutes of limitation governing a claim available to a debtor, but only where the limitations "period has not expired before the filing of the petition." 11 U.S.C. § 108(a). The Court in fact has observed that a bankruptcy estate "succeeds to no more or greater causes of action against third parties than those held by the debtor" immediately prior to the bankruptcy petition date. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204 n.8 (1983). Congress likewise observed in the Code's legislative history: "[The Code] is not intended to expand the debtor's rights against others more than they exist at the commencement of the case. For example, if the debtor has a claim that is barred at the time of the commencement of the case by the statute of limitations, then the trustee would not be able to pursue that claim, because he too would be barred. *He could take no greater rights than the debtor himself had.*" S. Rep. 95-989 (1978), at 82 (emphasis added).[7]

As with its disregard of California's burden of proof, the court of appeals' plain error in refusing to enforce the statue of limitations changed the outcome in this case. If the court had applied the state statute, the petitioners would have prevailed. The failure to follow this Court's

[7] The court of appeals wrongly held that California's statute of limitations was bankruptcy specific and therefore preempted by the Bankruptcy Code. App. at 17. In fact, the California statute has nothing to do with bankruptcy law. It applies to all challenges to the validity and enforceability of a specified category of government agreements. Those challenges could be and are frequently made outside of bankruptcy, as are challenges to the "true lease" nature of agreements.

decisions is a grievous error worthy of correction by the Court.

III. The Opinion Below Nullifies An Established Method Of Funding Improvements Of Public Property And Has Far-Reaching Negative Consequences.

The context of this case highlights the need for the Court to articulate a clear, unambiguous rule as to what constitutes a "lease" for purposes of the Bankruptcy Code.

First, the court of appeals essentially nullified (or at least made much more expensive) an important mechanism for funding improvements to public property like airports. For decades, public agencies have used lease revenue bonds to raise money to renovate and construct public facilities. Lease revenue bonds involve the lease or sublease of a portion of public property from a government agency, coupled with a pledge of the rent payable under the lease/sublease to the repayment of the bonds. One fundamental aspect of this structure – and the reason why it enhances credit ratings and lowers the cost of borrowing – is the ability of the agency-lessor (or its bond trustee assignee) to enforce the lease by evicting the lessee and re-renting the property in the event of nonpayment, just as a commercial landlord can evict a delinquent tenant and re-rent office property if rent is not paid.

By concluding that debtors like United can repudiate or recharacterize the leases that underpin lease revenue bonds without fear of eviction or other consequences, the court of appeals may have wiped out an entire category of municipal financing, one that has been used repeatedly and extensively in connection with airports and other vital

air transportation facilities. According to the *amicus* brief submitted to the bankruptcy court by the Bond Market Association and the National Federation of Municipal Analysts:

> Recharacterizing the Facilities Leases as "debt" calls into question the underlying premise of governmental ownership of the Airport Facilities financed by the Airport Special Facilities Bonds – as a matter of the reasonable expectations of the credit markets, as well as a matter of tax law and as a matter of economics. *The market has relied* – not only in the case of United but also in connection with many other airline special facility financings involving billions of dollars – *on governmental ownership as a basic premise for the tax-exempt status of the bonds and for the basic security structure of the financing.* If United succeeds in its efforts to recharacterize the Lease Arrangements, United's position undercuts one of the most fundamental elements of the carefully developed system for airport financing. Absent the market being able to rely on the contractual obligations entered into by United (and other airlines), *Airport Special Facility Bonds will no longer be an economical and efficient tool for the development of air transportation facilities.* To the extent that Airport Special Facility Bonds can even be brought to market in an environment where the market can no longer rely upon the positions being taken by the airlines, the market will exact a high cost for taking on the added risk of those financings. *That inability to "tap the market," or the ability to access the market only at a high cost,* defeats not only the purpose of Airport Special Facility Bond financing, but also *threatens the viability of one of*

the most heavily utilized development tools for the air transportation system.

Amicus Curiae Brief Of The Bond Market Association And The National Federation Of Municipal Analysts Relating To Debtor's Motions For Summary Judgment And Cross Motions For Summary Judgment, at 13 (emphasis added).

These warnings lend particular force to the Eleventh Circuit's observation that "the application of bankruptcy principles in this context [of municipal financing] would be particularly inappropriate." *Martin Brothers*, 796 F.2d at 1440.

Moreover, the court of appeals opened the door to a potential floodgate of challenges by other airlines. In the few months following issuance of the court's opinion, the nation's third- and fourth-largest airlines (Delta Air Lines and Northwest Airlines) filed for bankruptcy in other districts, and Delta already has initiated challenges identical to that made by United. Billions of dollars of airport lease revenue bonds currently are outstanding. Given the current precarious state of the airline industry, many of those bonds are now at serious risk of nullification as a result of the court's opinion.

This turn of events, and the opinion's far-reaching impact on municipal financing, make this case ripe for review by the Court. *Cf. Securities Industry Ass'n v. Board of Governors*, 468 U.S. 137, 142 (1984) (granting certiorari "[b]ecause of the importance of the issue for the Nation's financial markets").

CONCLUSION

The Petition should be granted to resolve the several conflicts among the circuits with respect to this important issue involving the intersection of bankruptcy law, state law, and municipal financing, and to address the court of appeals' manifest misapplication of several of this Court's precedents.

Respectfully submitted,

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416 F.3d 609

United States Court of Appeals,
Seventh Circuit.
UNITED AIRLINES, INC., Plaintiff-Appellant,
v.
HSBC BANK USA, N.A., as Trustee, and California Statewide Communities
Development Authority, Defendants-Appellees.
Nos. 04-4209, 04-4315, 04-4321.

Argued May 5, 2005.
Decided July 26, 2005.
Rehearing and Rehearing
En Banc Denied Aug. 23, 2005.*

Harold L. Kaplan, Gary W. Garner and Mark F. Hebbeln, Gardner, Carton & Douglas, Chicago, IL, Kirk D. Dillman, James O. Johnston (argued), Hennigan, Bennett & Dorman, Los Angeles, CA, for Appellee HSBC Bank USA, N.A.

R. Dale Ginter, Jamie P. Dreher (argued), Downey Brand, Sacramento, CA, for Appellant.

James H.M. Sprayregen, Marc Kieselstein (argued), Kirkland & Ellis, Chicago, IL, for Debtor-Appellant.

William P. Smith, McDermott, Will & Emery, Chicago, IL, for Amicus Curiae, Bank of New York.

Douglas W. Jessop, Jessop & Co., Amicus Curiae, City of Denver.

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* Judge Ripple took no part in the consideration of this matter.

David A. Golin, Gesas, Pilati, Gesas & Golin, Chicago, IL, for Amicus Curiae, Regional Airports Improvement Corp.

Charles P. Schulman, Sachnoff & Weaver, Chicago, IL, for Amicus Curiae, City of Los Angeles.

Before BAUER, EASTERBROOK, and MANION, Circuit Judges.

EASTERBROOK, Circuit Judge.

What is a "lease" in federal bankruptcy law? Businesses that do not pay up front for assets may acquire them via unsecured debt, secured debt, or lease; in each event the business pays over time. Similar economic function implies the ability to draft leases that work like security agreements, and secured loans that work like leases. Yet the Bankruptcy Code of 1978 distinguishes among these devices. A lessee must either assume the lease and fully perform all of its obligations, or surrender the property. 11 U.S.C. § 365. A borrower that has given security, by contrast, may retain the property without paying the full agreed price. The borrower must pay enough to give the lender the economic value of the security interest; if this is less than the balance due on the loan, the difference is an unsecured debt. See 11 U.S.C. § 506(a) and § 1129(b)(2)(A). There are other ways in which the Code treats leases differently from security interests, but they don't matter to today's dispute.

During the 1990s United Air Lines entered into complex transactions to obtain money to build or improve premises at four airports – San Francisco, Los Angeles, Denver, and John F. Kennedy in New York. For each airport, a public body issued bonds that, because of the

issuer's status as a unit of state government, paid interest that is free of federal taxation. The public bodies turned this money over to United against its promise to retire the bonds and reimburse administrative costs. At each airport, United entered into a lease giving the body that had issued the bonds the right to evict United from operational facilities if it did not pay.

When United entered bankruptcy in 2002, however, it took the position that none of these transactions is a "lease" for purposes of § 365. United proposed to treat each transaction as a secured loan, so that it could continue using the airport facilities while paying only a fraction of the promised "rent." Chief Bankruptcy Judge Wedoff concluded that the word "lease" in § 365 – a term not defined anywhere in the Bankruptcy Code – includes "true leases" but not transactions where the form of a lease is used but the substance is that of a security interest. Applying this approach as a matter of federal law, Judge Wedoff concluded that the Denver transaction is a true lease but that the other three are not. *In re UAL Corp.*, 307 B.R. 618 (Bankr.N.D.Ill.2004). This meant that United had to cure the default and resume full payments on its Denver deal but could reduce its payments on the other transactions and treat the difference as unsecured debt.

Everyone appealed. The district judge issued four opinions, one for each airport, and held that all four transactions are "true leases." Two are published: *United Air Lines, Inc. v. HSBC Bank USA*, 322 B.R. 347 (N.D.Ill.2005) (Denver), and *HSBC Bank USA v. United Air Lines, Inc.*, 317 B.R. 335 (N.D.Ill.2004) (San Francisco). Relying principally on *Butner v. United States*, 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979), and *In re Powers*, 983 F.2d 88 (7th Cir.1993), Judge Darrah first

concluded that state rather than federal law controls the distinction between security interests and leases. Then, applying California, Colorado, and New York law, he held that each transaction must be treated as a "lease." United has appealed in all of these adversary actions. The San Francisco dispute has been fully briefed; the other appeals are being held for the disposition of this one. Parties to the Los Angeles, Denver, and New York transactions have presented their views as *amici curiae*. We confine our attention in this opinion to the San Francisco transaction.

Since 1973 United has been the lessee of 128 acres, used for a maintenance base, at San Francisco International Airport. The lease will end in 2013 unless the parties negotiate an extension; rent depends on an independent party's estimate of the property's market value. In 1997 the California Statewide Communities Development Authority (CSCDA) issued $155 million in bonds for United's benefit. United received the proceeds for use in improving its facilities at the Airport – though not at the maintenance base. The transaction was accomplished through four documents.

- *The sublease.* United subleases 20 acres of the 128-acre maintenance base to the CSCDA for 36 years. This term matches the debt-repayment schedule rather than United's lease with the Airport. The total rent CSCDA pays is $1.

- *The leaseback.* The CSCDA leases the 20 acres back to United for a rent (paid to HBSC Bank as the Indenture Trustee) equal to interest on the bonds plus an administrative fee. The lease has a $155 million balloon payment in 2033 to retire the principal. United may postpone final payment until 2038; if it does, the sublease also is extended. United also is entitled to prepay; if it

does, the sublease and leaseback terminate. If United does not pay as agreed, the CSCDA may evict it from the 20 acres. The leaseback includes a "hell or high water" clause: United must pay the promised rent even if its lease from the Airport ends before 2033, the property is submerged in an earthquake (the Airport abuts San Francisco Bay), or some other physical or legal event deprives United of the use or economic benefit of the maintenance base.

• *The trust indenture.* The CSCDA issues the bonds, turns the $155 million over to United against the promises made in the sublease, and arranges for the Trustee to receive United's payments for distribution to the bondholders. The bonds are without recourse against the CSCDA.

• *The guaranty.* United commits its corporate treasury to repayment of the bonds.

That the sublease and leaseback have the form of "leases" is unquestioned. But does § 365 use form, or substance, to distinguish "leases" from secured credit?

Although the statute does not answer that question in so many words, every appellate court that has considered the issue holds, and the parties agree, that substance controls and that only a "true lease" counts as a "lease" under § 365. See *In re PCH Associates,* 804 F.2d 193, 198-200 (2d Cir.1986); *In re Pillowtex, Inc.,* 349 F.3d 711, 716 (3d Cir.2003); *In re Moreggia & Sons, Inc.,* 852 F.2d 1179, 1182-84 (9th Cir.1988); *In re Pacific Express, Inc.,* 780 F.2d 1482, 1486-87 (9th Cir.1986). See also, e.g., *In re Continental Airlines, Inc.,* 932 F.2d 282 (3d Cir.1991) (same under 11 U.S.C. § 1110, another part of the Code dealing with leases). We'll return to what a "true lease" might be; that term is no more self-defining than the bare word "lease."

Before fleshing out the definition, we explain why we agree with these decisions, because the reasons for preferring substance over form affect *which* substantive features of the transactions matter.

Whether the word "lease" in a federal statute has a formal or a substantive connotation is a question of federal law; it could not be otherwise. See *Reves v. Ernst & Young,* 494 U.S. 56, 71, 110 S.Ct. 945, 108 L.Ed.2d 47 (1990); *Bryant v. Yellen,* 447 U.S. 352, 370-71 & n. 22, 100 S.Ct. 2232, 65 L.Ed.2d 184 (1980). (Whether federal law incorporates state law to answer the questions that result from this choice is a different issue, to which we turn later. Cf. *United States v. Kimbell Foods, Inc.,* 440 U.S. 715, 99 S.Ct. 1448, 59 L.Ed.2d 711 (1979).) The Bankruptcy Code specifies different consequences for leases and secured loans. If these were formally distinct – in the way that mergers and asset sales in corporate law are distinct – then the statutory reference might best be understood as adopting the established forms. But "lease" is a label rather than a form. A transaction by which A sells a widget to B in exchange for periodic payments, with B to own the asset after the last payment, could be structured as an installment sale, a loan secured by the asset, or a lease, with only a few changes in verbiage and none in substance. It is unlikely that the Code makes big economic effects turn on the parties' choice of language rather than the substance of their transaction; why bother to distinguish transactions if these distinctions can be obliterated at the drafters' will?

Many provisions in the Code, particularly those that deal with the treatment of secured credit, are designed to distinguish financial from economic distress. A firm that cannot meet its debts as they come due, but has a positive

cash flow from current operations, is in financial but not economic distress. It is carrying too much debt, which can be written down in a reorganization. A firm with a negative cash flow, by contrast, is in economic distress, and liquidation may be the best option. In order to distinguish financial from economic distress, the Code effectively treats the date on which the bankruptcy begins as the creation of a new firm, unburdened by the debts of its predecessor. See generally *Boston & Maine Corp. v. Chicago Pacific Corp.*, 785 F.2d 562 (7th Cir.1986). The new firm must cover all new expenses, while debt attributable to former operations is adjusted. Section 365, which deals with leases, classifies payments for retaining airplanes and occupying business premises as new expenses, just like payments for labor and jet fuel. The rules for credit, by contrast, treat debt service as an "old" expense to be adjusted to deal with financial distress.

This works nicely when rent under a lease really *does* pay for new inputs: each monthly payment on an airplane lease covers another month's use of a productive asset, just as payments for jet fuel do. But "rent" that represents the cost of funds for capital assets or past operations rather than ongoing inputs into production has the quality of debt, and to require such obligations to be assumed under § 365 to retain an asset would permit financial distress from past operations to shut down a firm that has a positive cash flow from current operations. Imagine a lease of an airplane with a 20-year economic life that provided for no rental payments during the first 10 years, followed by rent at 2.5 times the market rate for the last ten (it exceeds twice the spot-market price because the payments must cover accrued interest on the deferrals). To separate financial from economic distress it would be essential to

separate the loan components of that "lease" from the current-consumption components. The cost of capital hired before the bankruptcy could be written down while the expenses of current operations continued to be met.

When Congress enacted the Bankruptcy Code in 1978, the legal system afforded rules that facilitated the disentangling of credit and consumption components of leases. Since 1939 this had been routine in tax law. See *Helvering v. F & R Lazarus & Co.*, 308 U.S. 252, 60 S.Ct. 209, 84 L.Ed. 226 (1939). See also, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978). During the 1940s and 1950s much state law on the subject was summed up and codified in the Uniform Commercial Code. Section 1-201(37) of the 1958 Official Text separates credit components, in which the asset serves as security, from consumption components this way:

> Unless a lease . . . is intended as security, reservation of title thereunder is not a "security interest". . . . Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.

A lease in which the consumption component dominates often is called a "true lease," while one in which the asset serves as security for an extension of credit is treated as a security agreement governed by the UCC's Article 9.

No legally sophisticated person writing in 1978 could have thought that the word "lease" in a text that distinguishes between current consumption (which must be paid for in full) and secured debt (which may be written down to ease financial distress) means any transaction in the form of a lease. The need to look through form to substance would be apparent not only from the structure of the statute but also from the fact that many of the leased assets would be covered directly by the UCC. Section 365 in particular deals with leases of both personal and real property; it would not be sensible to read the same word as referring to substance when dealing with personal property and form when dealing with real property. The statute thus must refer to substance throughout § 365. Nothing else respects both the structure of the Bankruptcy Code and the way the legal community understood the distinction between leases and security agreements in the 1970s.

Because the parties have made so much of the legislative history, we add that the understanding that § 365 deals with substance rather than form is reflected in many of the documents that precede the Code's enactment. The passage to which the litigants pay the most attention reads:

> The phrase 'lease of real property' applies only to a 'true' or 'bona fide' lease and does not apply to financing leases of real property or interests therein, or to leases of such property which are intended as security.
>
> [I]n a true lease of real property, the lessor retains all risk and benefits as to the value of the real estate at the termination of the lease . . .

> Whether a 'lease' is [a] true or bona fide lease or, in the alternative, a financing 'lease' or a lease intended as security, depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not, for example, upon the locus of title, the form of the transaction or the fact that the transaction is denominated as a 'lease'. The fact that the lessee, upon compliance with the terms of the lease, becomes or has the option to become the owner of the leased property for no additional consideration [or] for nominal consideration indicates that the transaction is a financing lease or lease intended as security. In such cases, the lessor has no substantial interest in the leased property at the expiration of the lease term. In addition, the fact that the lessee assumes and discharges substantially all the risks and obligations ordinarily attributed to the outright ownership of the property is more indicative of a financing transaction than of a true lease. The rental payments in such cases are in substance payments of principal and interest either on a loan secured by the leased real property or on the purchase of the leased real property.

S.Rep. No. 989, 95th Cong., 2d Sess. 64 (1978). This passage is interesting because it illustrates how the legal community thought in 1978 about the roles of form versus substance in dealing with a word such as "lease." It would be a mistake to find rules of decision in this un-enacted passage, see *American Hospital Association v. NLRB,* 499 U.S. 606, 615-16, 111 S.Ct. 1539, 113 L.Ed.2d 675 (1991), but it does show that Congress shared the legal community's understanding that some transactions with the form of a lease are best treated as security agreements.

To say that substance prevails over form as a matter of federal law is not to resolve all issues of detail – or for that matter to imply that federal law supplies the details. Which *aspects* of substance matter? The Senate Report does not supply the answer. "[R]estrictive language contained in Committee Reports is not legally binding." *Cherokee Nation v. Leavitt,* ___ U.S. ___, ___, 125 S.Ct. 1172, 1182, 161 L.Ed.2d 66 (2005). Reports are not enacted and do not create rules independent of the text in the United States Code. Anyway, this report sounds like a reminder to be sensible rather than a formulary.

Because nothing in the Bankruptcy Code says which economic features of a transaction have what consequences, we turn to state law. All of the states have devoted substantial efforts to differentiating leases from secured credit in commercial and banking law. Leases are state-law instruments, after all, and the norm in bankruptcy law is that contracts (of which leases are a species) and property rights in general have the same force they would have in state court, unless the Code overrides the state entitlement. See *Butner v. United States,* 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979); see also, e.g., *Raleigh v. Illinois Department of Revenue,* 530 U.S. 15, 20, 120 S.Ct. 1951, 147 L.Ed.2d 13 (2000); *BFP v. Resolution Trust Corp.,* 511 U.S. 531, 544-45, 114 S.Ct. 1757, 128 L.Ed.2d 556 (1994); *Nobelman v. American Savings Bank,* 508 U.S. 324, 329-30, 113 S.Ct. 2106, 124 L.Ed.2d 228 (1993); *Barnhill v. Johnson,* 503 U.S. 393, 398, 112 S.Ct. 1386, 118 L.Ed.2d 39 (1992). A state law that identified a "lease" in a formal rather than a functional manner would conflict with the Code, because it would disrupt the federal system of separating financial from economic distress; a state approach that gives a little more or a little less

weight to one of several "factors" does not conflict with any federal rule, because there is none with which it *could* conflict. Cf. *In re James Wilson Associates,* 965 F.2d 160 (7th Cir.1992).

United contends that the second and ninth circuits have held that federal law supplies the definition of a "lease" in addition to establishing a functional approach to the inquiry. Perhaps some language in *PCH Associates* and *Moreggia* could be read that way, though we think it more likely that both courts were concerned with the first question (whether the word "lease" in § 365 has a formal or functional scope), which is a matter of federal law, than with the second – what body of law identifies a "true lease" under the functional approach? Neither opinion cites *Butner* or any of the Supreme Court's other decisions specifying that state law must be used whenever possible to define the interests on which the Code operates. If either the second or the ninth circuits believes that federal law answers *all* questions concerning the operation of § 365, then we disagree; for the reasons we have given, the third circuit (which in *Continental Airlines* and *Pillowtex* used state definitions) got this right. Indeed, we held exactly this in *Powers,* a decision under § 365 that the bankruptcy judge did not mention. *Powers* involves the choice between lease and installment sales contract for personal property; we cannot imagine any reason why state law would define a "true lease" for personal property while federal law would supply the definition for real property.

So what does California law provide? The district judge thought that California allows form to control, and because United and the CSCDA chose the form of a lease United is stuck with that characterization under § 365. If

indeed California identifies leases in such a mechanical fashion, then its law must yield, but we do not understand it to distinguish leases from secured credit in this way. Neither do we follow the district court's conclusion that form prevails unless "clear and convincing evidence" supports a different characterization. Burdens of proof and persuasion are supplied by the forum, not by the source of substantive law. Bankruptcy law uses the preponderance standard. See *Grogan v. Garner*, 498 U.S. 279, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991). Anyway, burdens of persuasion are irrelevant to characterization of documentary transactions. See, e.g., *In re Schoonover*, 331 F.3d 575, 577 (7th Cir.2003); *In re Weinhoeft*, 275 F.3d 604 (7th Cir.2001).

Like the district judge, the parties in this court seek to find California's law in the decisions of federal bankruptcy judges sitting in California, and they debate the significance of what these judges have said about the subject. Yet federal judges are not the source of state law or even its oracles. To find state law we must examine California's statute books and the decisions of its judiciary. California has enacted the UCC; there can be no doubt that it uses a functional approach to separating leases from secured credit with respect to personal property. California takes a similar approach for real property as a matter of common law. *Burr v. Capital Reserve Corp.*, 71 Cal.2d 983, 80 Cal.Rptr. 345, 458 P.2d 185 (1969), and *Beeler v. American Trust Co.*, 24 Cal.2d 1, 147 P.2d 583 (1944), are especially revealing.

Beeler arose from a sale and leaseback of real property. When the tenant stopped paying, the court had to decide whether he could be evicted under landlord-tenant law, with the landlord retaining the fee title to the property, or

whether instead the tenant retained an equity of redemption under the law of mortgage loans, so that any payments in excess of the market rental value would redound to the tenant's benefit. The Supreme Court of California characterized the transaction as an equitable mortgage despite the fact that the papers cast it as an absolute deed plus a lease. It relied not only on the fact that the landlord was a financial institution but also on the fact that the rent was equal to the sum needed to pay off a loan and the fact that the lessee would become an owner after some years. (This is the UCC's *per se* rule: If the lessee has an option to acquire ownership at the end of the term for no or a nominal payment, then the transaction must be treated as secured credit.) The yearly rent was $3,000, substantially less than the going rate for similar property but exactly equal to the amount needed to amortize a $60,000 extension of credit – and the $60,000 for which the property had been "sold" initially was less than the market price of equivalent real estate. The state court thought that this deal had all the hallmarks of a mortgage loan except the form – and the form had to yield. This was not a "true lease" as the court saw it.

Burr posed the question whether a lease of personal property should be treated as a loan; the answer mattered because at the time California's usury law set a 10% maximum interest rate on loans, but there was no price control on leases. Burr needed money to expand his business. He obtained cash by selling some of the existing business's property to a bank and immediately leasing it back at a rental designed to amortize the extension of credit. The Supreme Court of California held that this form must be pierced to get at the substance: Burr had borrowed money on security of the property subject to the

lease, and as the interest rate in one of the parties' three transactions exceeded 10% the bank could not collect the full agreed payment.

California has applied this approach in many other cases, which we need not recount. See, e.g., *Lovelady v. Bryson Escrow, Inc.*, 27 Cal.App.4th 25, 32 Cal.Rptr.2d 371 (1994). It has been more willing to follow form when that will enhance tax revenues, denying parties a right to pierce their own form at the state's expense, when the state treasury was not privy to the original choice. See, e.g., *Rider v. San Diego,* 18 Cal.4th 1035, 77 Cal.Rptr.2d 189, 959 P.2d 347 (1998); *Dean v. Kuchel,* 35 Cal.2d 444, 218 P.2d 521 (1950). The only state decision to which the district judge referred is of this kind and held that it just did not matter whether a given transaction was a "lease" or something else. *Desert Hot Springs v. Riverside County,* 91 Cal.App.3d 441, 154 Cal.Rptr. 297 (1979). Instead the question was whether a person who had leased some land from a city for 50 years, built a city hall there, and leased the improved parcel back to the city for a 15-year term (substantially less than the structure's useful life), had retained a "possessory interest" subject to taxation under Cal. Rev. & Tax Code § 107. The court's affirmative answer is unhelpful on a question of the kind we confront. Whether the CSCDA has an interest that some other arm of California's government could tax is neither here nor there.

The transaction between United and the CSCDA is not a "true lease" under California law. (i) The "rent" is measured not by the market value of 20 acres within the maintenance base but by the amount United borrowed. The hell or high water clause demonstrates the lack of connection between the maintenance base's rental value

and United's financial obligation. (ii) At the end of the lease, the CSCDA has no remaining interest. The CSCDA stresses that United will not "own" anything as of 2033; it still would be the Airport's tenant. But its full tenancy interest reverts to it for no additional charge. Reversion without additional payment is the UCC's *per se* rule for identifying secured credit. (iii) The balloon payment has no parallel in a true lease, though it is a common feature of secured credit. (iv) If United prepays, the lease and sublease terminate immediately; in a true lease, by contrast, prepayment would secure the tenant's right to occupy the property for an additional period. The parties have not cited *any* case from *any* state deeming an arrangement of this kind to be a "true lease."

We do not doubt that many financing devices are true leases; the lessor owns the property and thus finances its acquisition, relieving the lessee of the need to raise funds itself, and net leases may measure rent by the lessor's financial commitments. United acquired many of its airplanes that way. But in such a transaction the lessee acquires an asset; from the lessee's perspective, it is engaged in securing assets with current value, and it can escape the rental obligation by surrendering the asset. United did not obtain the maintenance base from CSCDA; it already had the base under its lease from the Airport, and could not end the obligation to the CSCDA by vacating the maintenance base. What United did was use an asset (its leasehold interest in the maintenance base) to secure an extension of credit, just as the business did in *Burr*, and as in *Beeler* it agreed to pay "rent" equal to the price of that credit rather than any element of value in the "leased" premises.

The CSCDA has filed a cross-appeal to argue that United's failure to contest the lease within 60 days of its execution disables it from arguing that the arrangement is not a "true lease." California has what the parties call a "validation statute," which provides this deadline. Cal.Code Civ. P. § 860, § 869. The cross-appeal is pointless. The CSCDA wants us to affirm rather than alter the judgment, and appellees may advance in support of their judgments any argument preserved in the district court. *Massachusetts Mutual Life Insurance Co. v. Ludwig*, 426 U.S. 479, 96 S.Ct. 2158, 48 L.Ed.2d 784 (1976). The cross-appeal is dismissed as surplusage.

The district judge rejected the CSCDA's contention, stating that it had not been presented to the bankruptcy judge. Although the CSCDA says otherwise, we need not resolve that dispute. State procedures do not matter in bankruptcy. State law defines property rights, but federal law prescribes the hoops through which the litigants must jump. California could not enact a law saying: "§ 365 always must be applied to documents with the form of leases unless the debtor takes specified steps before entering bankruptcy." Matters that *could not* have been determined before bankruptcy can't be foreclosed because they *were not* so determined. See *Brown v. Felsen*, 442 U.S. 127, 99 S.Ct. 2205, 60 L.Ed.2d 767 (1979). Nor may states insist that questions affecting the outcome of a bankruptcy be adjudicated in state court; the federal bankruptcy jurisdiction is exclusive. Issues that have been resolved in state court (say, in pre-bankruptcy litigation) may well have preclusive effect in the federal litigation. See, e.g., *Grogan*, 498 U.S. at 284-85 n. 11, 111 S.Ct. 654; *Brown*, 442 U.S. at 139, 99 S.Ct. 2205; *Kelly v. Robinson*, 479 U.S. 36, 47-49, 107 S.Ct. 353, 93 L.Ed.2d 216 (1986). But states

may not compel potential debtors in bankruptcy to use state tribunals before repairing to federal court.

What is more, the state validation statute does not apply on its own terms. United is not challenging the *validity* of the sublease and leaseback. It concedes that the transaction is valid as a matter of state law and that it owes the money. The question under § 365 is whether it must pay in full to enjoy continued occupancy or whether, instead, it may reduce payments to the value of the interest secured by the leasehold and treat the residue as unsecured debt. California's validation statute does not address that question and so is irrelevant in this litigation.

The transaction between United and the CSCDA at San Francisco Airport is a secured loan and not a lease for the purpose of § 365. The judgment of the district court is reversed, and the case is remanded for further proceedings consistent with this opinion.

317 B.R. 335

United States District Court,
N.D. Illinois,
Eastern Division.
HSBC BANK USA, Appellant,
v.
UNITED AIR LINES, INC., Appellee.
California Statewide Communities Development Authority, Appellant,
v.
United Air Lines, Inc., Appellee.
Nos. 04 C 2836, 04 C 2837.

Nov. 16, 2004.

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Robert Dale Ginter, Downey Brand LLP, Sacramento, CA, for Defendant.

MEMORANDUM OPINION AND ORDER

DARRAH, District Judge.

This matter comes before the Court on the appeal of the judgment of the bankruptcy court of March 30, 2004, by HSBC Bank USA and California Statewide Communities Development Authority ("CSCDA"). For the reasons that follow, the decision of the bankruptcy court is reversed.

BACKGROUND

CSCDA is a joint exercise-of-powers government agency consisting of a number of California counties, cities, and other local government agencies. CSCDA is organized pursuant to Chapter 5 of Division 7 of Title 1 of the Government Code of the State of California ("Joint Powers Act") and an Amended and Restated Joint Exercise of Powers Agreement dated as of June 1, 1988, among the member local government agencies. Pursuant to the Joint Powers Act, CSCDA is authorized to exercise the power of its member local government agencies, among other things, to issue revenue bonds to pay the cost and expenses of acquiring or constructing publicly owned or operated commercial aviation airports and airport-related facilities.

On June 18, 1973, United entered into the "Maintenance Base Lease" with the City and County of San Francisco. Pursuant to the lease, United leased certain ramp space and facilities at San Francisco International Airport ("SFO"). To assist United in developing certain facilities at SFO, United and CSCDA consummated a transaction in 1997 pursuant to which CSCDA issued tax-exempt revenue bonds in the amount of $154,845,000.00. The funds from the sale of the bonds were made available to United in accordance with the terms of the 1997 SFO transaction documents.

The 1997 SFO transaction was comprised of multiple documents and agreements. Three agreements germane to the instant dispute are: (1) the Site Sublease, (2) the Facilities Lease, and (3) the Indenture of Mortgage and Deed of Trust ("Indenture").

Pursuant to the Site Sublease, United subleased to CSCDA an approximately twenty-acre portion of the premises leased to United under the Maintenance Base Lease for the nominal rent of one dollar. The term of the Site Sublease is defined as the period from September 1, 1997 to October 5, 2033, unless a shorter or longer period is required to retire bonds to be issued by CSCDA. There are no provisions for remedies for United for any default by CSCDA.

CSCDA then sub-subleased the leased premises back to United pursuant to the Facilities Lease. The term of the Facilities Lease is identical to that of the Site Sublease. The Facilities Lease's rental is the amount necessary to make the payments required under the Indenture – the amount needed to pay the bonds in accordance with their terms as well as administrative costs. The Facilities Lease's rental amount also constituted reasonable compensation for the use and occupation of the relevant portion of the SFO Maintenance Base Lease – the 20-acre portion of the 130-acres the City and County leased to United. The Facilities Lease provides default provisions and remedies, including CSCDA's right to take possession of the leased facilities and relet them if United fails to make the required payments.

The Indenture provides for the issuance of tax-exempt bonds by CSCDA, for the SFO trustee to receive the proceeds of the sale of bonds for purposes of funding construction of defined improvements benefiting United, and for the SFO trustee to receive the rental payments from United under the Facilities Lease for the purpose of paying the debt service on the bonds and ultimately retiring them. The Indenture indicates that the bonds are "limited obligations" of CSCDA, payable only from the

revenue received from United and earnings on this revenue. Pursuant to the Indenture, CSCDA assigned the Facilities Lease, including the right to collect rents, to the Indenture trustee, presently HSBC Bank USA.

On December 9, 2002, United filed a voluntary petition under Chapter 11 of Title 11, United States Code. On March 21, 2003, United filed an Adversary Complaint, seeking a declaratory judgment that certain of its payment obligations related to airport improvements were not obligations arising under "leases" pursuant to Section 365 of the Bankruptcy Code. Subsequently, all parties moved for summary judgment on the issue of whether the "leases" were true leases, as opposed to financing instruments.

On March 4, 2004, the bankruptcy court granted United's motion for summary judgment. HSBC Bank and CSCDA appeal that judgment to this Court.

LEGAL STANDARD

A bankruptcy court's grant of summary judgment is reviewed *de novo*. *Hoseman v. Weinschneider*, 322 F.3d 468, 473 (7th Cir.2003) (*Hoseman*). All of the facts and the inferences therefrom are viewed in the light most favorable to the nonmoving party. *Hoseman*, 322 F.3d at 473. Similarly, a bankruptcy court's interpretation of statute is a question of law reviewed *de novo*. *See Hiram Walker & Sons, Inc. v. Kirk Line*, 30 F.3d 1370, 1378 (11th Cir.1994). The Court reviews the bankruptcy court's factual findings for clear error. *Hoseman*, 322 F.3d at 473.

Summary judgment is proper if "the pleadings, depositions, answers to interrogatories, and admissions on file,

together with affidavits, if any, show that there is no genuine issue as to any material fact." Fed.R.Civ.P. 56(c); *see also Celotex Corp. v. Catrett,* 477 U.S. 317, 322-23, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). All the evidence and the reasonable inferences that may be drawn from the evidence are viewed in the light most favorable to the nonmovant. *Miller v. American Family Mut. Ins. Co.,* 203 F.3d 997, 1003 (7th Cir.2000). Summary judgment may be granted when no verdict could reasonably be returned for the nonmoving party. *See Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986).

DISCUSSION

The bankruptcy court held that the Site Sublease and the Facilities Lease between United and CSCDA were not true leases for purposes of Bankruptcy Code § 365, finding that the 1997 SFO transactions ". . . are the economic equivalent of leasehold mortgages. . . ." The bankruptcy court applied federal law to determine if the instruments were true leases, rather than applying state law, as argued by the Appellants.

The appeal raises the following issues for review: (1) did the bankruptcy court err by failing to apply state (California) law to characterize the Site Sublease and the Facilities Lease; (2) was it error for the bankruptcy court to ignore Seventh Circuit precedent; (3) did the bankruptcy court err in denying the Appellants' motions for summary judgment; and (4) did the bankruptcy court err in granting United's Motion for Summary Judgment.

The Appellants' first two arguments on appeal are interrelated. Appellants argue that the bankruptcy court erred in failing to apply state law, as required by Seventh

Circuit precedent, when determining whether the Site Sublease and the Facilities Lease constituted true leases for § 365 purposes.

Section 365(a) provides the trustee, or debtor-in-possession in Chapter 11 cases, the power to assume or reject unexpired leases. 11 U.S.C. § 365(a). Certain requirements are imposed when the trustee wishes to assume an unexpired lease in default. The trustee must cure the default, compensate any parties that have suffered pecuniary loss from the default, and provide adequate assurance of future performance under the lease. 11 U.S.C. § 365(b). Leases of nonresidential real property are deemed rejected unless assumed within sixty days after an order for relief unless the court, for cause, grants additional time during that sixty-day period. 11 U.S.C. § 365(d).

The terms "unexpired lease" and "lease of nonresidential real property," as used in Section 365, are not defined in the Bankruptcy Code. In defining the terms, courts have relied upon the legislative history of Section 502(b)(6) of the Bankruptcy Code, which limits damage claims resulting from lease terminations which are allowable to a debtor's landlord. The pertinent legislative history states:

> Whether a "lease" is a true or [a] bona fide lease, or in the alternative, a financing "lease" or a lease intended as security, depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not, for example, upon the locus of title, the form of the transaction or the fact that the transaction is denominated as a "lease."

S.Rep. No. 598, 95th Cong., 2d Sess. 64, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5850. Based on this legislative history, courts require that a lease in question must be a "true" or "bona fide" lease for Section 365 to apply. *See In re Powers*, 983 F.2d 88, 89 (7th Cir.1993) (deciding whether rental agreements were true leases) (*Powers*); *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 1182 (9th Cir.1988) (*Moreggia*); *In re Lunan Family Restaurants*, 194 B.R. 429, 450 (Bankr.N.D.Ill.1996); *In re Hotel Syracuse, Inc.*, 155 B.R. 824, 838 (Bankr.N.D.N.Y.1993) (*Hotel Syracuse*).

Generally, Congress has left the determination of property rights in the assets of a bankrupt's estate to state law. *See Butner v. United States*, 440 U.S. 48, 54, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979) (*Butner*). The application of state law is applied to both ownership interests in property and security interests in such property. *Nobelman v. American Savings Bank*, 508 U.S. 324, 329, 113 S.Ct. 2106, 124 L.Ed.2d 228 (1993). However, state law may be displaced if "some federal interest requires a different result." *Butner*, 440 U.S. at 55, 99 S.Ct. 914. In order to displace traditional state law, "the federal, statutory purpose must be 'clear and manifest.' . . . Otherwise, the Bankruptcy Code will be construed to adopt, rather than displace, pre-existing state law." *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 544-45, 114 S.Ct. 1757, 128 L.Ed.2d 556 (1994). "In the absence of any controlling federal law, 'property' and 'interests in property' are creatures of state law." *Barnhill v. Johnson*, 503 U.S. 393, 398, 112 S.Ct. 1386, 118 L.Ed.2d 39 (1992).

"Lease" is not defined in Section 365. However, the legislative history applicable to a security interest states that "[w]hether a consignment or a lease constitutes a security interest under the bankruptcy code will depend

on whether it constitutes a security interest under applicable state or local law." S.Rep. No. 595, 95th Cong., 1st Sess. 314, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6271; *see also Powers,* 983 F.2d at 90; *DWE,* 157 B.R. at 330 (citing legislative history of definition of security interest in support of application of state law in application of Section 365). This legislative history supports a finding that the bankruptcy code, as applied to leases in Section 365, adopts, rather than displaces, pre-existing state law.

Furthermore, the legislative history of Section 502(b)(6) cited above fails to demonstrate a "clear and manifest" statutory purpose to displace traditional state law. *See BFP,* 511 U.S. at 544-45, 114 S.Ct. 1757. This legislative history indicates that whether a lease is a true lease depends upon the circumstances of each case. This requirement is consistent with state laws requiring that the facts of each case be reviewed to determine whether a lease is intended as security. *See, e.g., Powers,* 983 F.2d at 90 (Illinois and Indiana law require court to determine whether a lease is intended as security by the facts of each case); *Pillowtex,* 349 F.3d at 717 (under New York law, whether a transaction creates a lease or security interest is determined on a case-by-case basis); *Pittsburgh Sports,* 239 B.R. at 84 (Pennsylvania law requires an examination of the particular facts and circumstances of each case).

This legislative history also states that the "distinction between a true lease and a financing agreement is based upon the economic substance of the transaction." Reviewing the "economic substance" or "economic realities" is consistent with state law. *See In re Yarbrough,* 211 B.R. 654, 657 (Bankr.W.D.Tenn.1997) (Mississippi law requires the court to look to the economic realities of the transaction in determining whether a transaction is a

lease or security interest); *In re Vital Prod. Co.*, 210 B.R. 109, 112 (Bankr.N.D.Ohio 1997) (Ohio state law, as provided in the U.C.C., focuses on economic realities of a transaction in determining whether the transaction is a true lease); *In re Nite Lite Inns,* 13 B.R. 900, 907-08 (Bankr.S.D.Cal.1981) (*Nite Lite*) (considering the economic substance of the transaction in applying California law to determine whether transaction was a true lease); *In re Hoagland,* 1996 WL 33406128 (Bankr.C.D.Ill. Feb. 26, 1996) (the economic realities of the transaction are relevant factors under Illinois law in determining whether a lease is a true lease). Accordingly, the legislative history of Section 502(b) fails to demonstrate a clear and manifest statutory purpose to displace traditional state law. *See BFP,* 511 U.S. at 544-45, 114 S.Ct. 1757. In essence, United concedes this as it argues that the substantive inquiry under both California law and federal law is the same.

Federal courts, including the Seventh Circuit, have applied state law in determining whether a lease is a true lease for purposes of Section 365, citing *Butner. See Powers,* 983 F.2d at 90; *In re Pillowtex, Inc.,* 349 F.3d 711, 716 (3rd Cir.2003) (*Pillowtex*); *In re Sankey,* 307 B.R. 674, 678 (D.Alaska 2004); *In re Pittsburgh Sports Assoc. Holding Co.,* 239 B.R. 75, 83 (Bankr.W.D.Pa.1999) (*Pittsburgh Sports*); *In re Fox,* 229 B.R. 160, 164 (Bankr.N.D.Ohio 1998); *In re DWE Screw Prod., Inc.,* 157 B.R. 326, 330 (Bankr.N.D.Ohio 1993) (*DWE*).

In contrast, some courts, including the bankruptcy court here, have applied a federal rule of law, known as the economic realities test, to determine whether a lease is a true lease for purposes of Section 365. These courts cite the above-quoted language of the legislative history of

Section 502(b)(6), read together with Section 365, in support of their finding that a federal rule of law must be applied in determining whether a lease of real property[1] is a true lease for purposes of Section 365 because these aspects provide an adequate "federal interest" to justify using a federal rule of law rather than state law to define this particular property interest. *See Moreggia*, 852 F.2d at 1182; *In re PCH Assoc.*, 804 F.2d 193, 200 (2nd Cir.1986) (*PCH*); *In re KAR Dev. Assoc., L.P.*, 180 B.R. 629, 638 (D.Kan.1995) (*KAR*); *In re Tak Broadcasting Corp.*, 137 B.R. 728, 732 (W.D.Wis.1992).

However, based on the legislative history and the case law, particularly *Butner* and *Powers*, the bankruptcy court erred in applying federal law in determining whether the leases at issue were true leases.

The Appellants' third and fourth issues are also related. Appellants argue that the bankruptcy court erred in granting United's motion for summary judgment and denying the Appellants' motions for summary judgment. United argues that summary judgment was proper under either federal law or California law because, substantively, the law is the same.

Under California law, an agreement is *presumptively* a lease of real property if it includes a designation of the parties, contains a definite description of the leased property, provides for periodic payment of rent for the term of the lease, and provides a right to occupy the

[1] Those sections of Section 365 applicable to both real and personal property are specifically indicated. *See, e.g.*, 11 U.S.C. § 365(d)(1). Any section applicable to only real property is specifically identified. *See, e.g.*, 11 U.S.C. § 365(d)(4).

property to the exclusion of the grantor. *See In re SCCC Assoc. II Ltd.*, 158 B.R. 1004, 1013 (Bankr.N.D.Cal.1993) (*SCCC*) (emphasis added).

Here, the Facilities Lease designates the parties, contains a definite description of the leased property, provides for periodic payment of rent over the term of the lease, and provides United with a right to occupy the leased premises to the exclusion of the grantor. Accordingly, the Facilities Lease is presumed to be a true lease under California law. This presumption may be rebutted by United by establishing by *clear and convincing evidence* that the parties intended for the Facilities Lease to disguise a substantive transfer of ownership of or an encumbrance of the leased SFO Maintenance Facility. *See SCCC*, 158 B.R. at 1009-14; *Fox v. Peck Iron & Metal Co.*, 25 B.R. 674, 688 (Bankr.S.D.Cal.1982) (*Fox*) (emphasis added).

Whether a lease agreement is a true lease or one intended solely for security is determined by determining the intent of the parties at the time of the execution of the document. *See Fox*, 25 B.R. at 688. The intent of the parties is determined by reviewing all facts and circumstances of the transaction, including the economic substance of the transaction. *See Fox*, 25 B.R. at 688; *Nite Lite*, 13 B.R. at 908. Factors considered in this analysis include: (1) whether the transaction actually transfers the normal risks and responsibilities of landlord to the lessor; (2) whether the payments under the lease are reasonably designed to compensate the lessor for the use of the property or simply reflect the repayment of the lessor's acquisition cost plus interest; *Fox*, 25 B.R. at 688; and (3) whether the lessor retains an economically significant interest in the property, *SCCC*, 158 B.R. at 1013.

The application of these factors to the facts demonstrates that the Facilities Lease was a true lease. Under the Facilities Lease, United is required to pay the taxes, maintenance, and insurance – generally referred to as a triple net lease. While the payment of taxes, maintenance, and insurance are typically viewed as usual obligations indicating ownership, as opposed to a landlord-tenant relationship, the use of triple net leases are not unusual terms in ground leases. *See SCCC,* 158 B.R. at 1013. Furthermore, United concedes that it could never own the leased property or facilities. As such, United's responsibilities under the lease that are generally an indicia of ownership fail to demonstrate that the lease is not a true lease.

The payments under the lease are also reasonably designed to compensate Appellants. The aggregate rental payments required by the Facilities Lease include the amount needed to pay the bonds in accordance with their terms and the administrative costs associated therewith. However, the amount of the rental payments also constituted reasonable compensation for the use and occupation of the 20-acre portion of the 180-acre SFO Maintenance Facilities. HSBC's expert demonstrated that United's rent payments were reasonable compensation for the use and occupation of the relevant portion of the SFO Maintenance Facilities. United provided no evidence to the contrary. Furthermore, rent payments are frequently calculated with reference to payment in respect to financing obligations. *See City of Desert Hot Springs v. County of Riverside,* 91 Cal.App.3d 441, 154 Cal.Rptr. 297, 301 (1979) (*Desert Springs*). A "'lease-leaseback' arrangement 'as a method of financing construction' is not inconsistent with the existence of a lease." *Desert Springs,* 154 Cal.Rptr. at 301. In addition, United could terminate the Facilities

Lease by prepaying the rent due for the lease term, and there was no reduction in rent corresponding to the shorter lease term in the event of prepayment. An absolute obligation to pay rent for the full lease term is indicative of a true lease. *See 7 Miller & Star California Real Estate* § 19.86 (3d ed.2001).

Lastly, the lessor retained an economically significant interest in the property leased to United, and United retained no interest in the leased property. United concedes that it did not own, will not own, and cannot ever own any of the facilities leased to United. The Facilities Lease does not have an option to purchase at the end of the lease. United has retained no interest at the end of the lease.

United argues, and the bankruptcy court found, that because CSCDA does not retain an ownership interest at the end of the Facilities Lease, the Facilities Lease cannot be a true lease. The bankruptcy court held this factor to be the most important and concluded that the Facilities Lease was not a true lease based on this factor alone. However, this analysis and resultant finding focus on the lessor instead of the lessee. The finding also fails to take into account that CSCDA had a right to re-let the relevant portion of the SFO Maintenance Facilities if United defaulted. The right to re-let is indicative of a true lease, not a financing arrangement.

Under the bankruptcy court's logic, every sublease that has a term equal to the term of the underlying lease would be a disguised financing arrangement rather than a true lease because the sublessor has a lack of reversionary interest at the end of the lease term. For example, if lessor A executed a one-year lease of an apartment with lessee B,

and lessee B subleased the apartment six months later to sublessee C for the remaining six months, at the conclusion of the sublease, the apartment reverts back to lessor A. Under the bankruptcy court's reasoning, the sublease would not be a true lease because lessee B did not have a reversionary interest at the end of the lease term. Accordingly, the lack of a reversionary interest in CSCDA at the end of the Facilities Lease does not dictate that the Facilities Lease was not a true lease.

The Appellants also argue that United is equitably estopped from changing its previous position that the Facilities Lease was a lease. Under California law, the elements of equitable estoppel are: (1) the party to be estopped must be appraised of the facts; (2) that party must intend that its conduct be acted upon, or must so act that the other party has a right to believe that it was so intended; (3) the other party must be ignorant of the true state of facts; and (4) the other party must rely on the conduct to its injury. *See Ace Am. Ins. Co. v. Walker*, 121 Cal.App.4th 1017, 18 Cal.Rptr.3d 1, 8 n. 2 (2004). Here, there is no evidence demonstrating that United was appraised of the fact that it would be filing for bankruptcy and that the Facilities Lease would be an issue of dispute. Accordingly, the doctrine of equitable estoppel is not applicable.

Lastly, the Appellants argue that, under California law, United had sixty days to challenge the Facilities Lease and that United failed to do so; therefore, United cannot now challenge the lease. Nothing in the record indicates that Appellants presented this argument to the bankruptcy court, and the bankruptcy court did not address the issue in its March 30, 2004 judgment now on appeal before this Court. Accordingly, this issue is waived

on appeal. *See In re Image Worldwide, Ltd.*, 139 F.3d 574, 581 (7th Cir.1998).

CONCLUSION

Based on the foregoing, the March 30, 2004 judgment of the bankruptcy court order, granting summary judgment in favor of United based on its finding that the Facilities Lease was not a true lease, is reversed.

United States District Court,
Northern District of Illinois

Name of Assigned Judge or Magistrate Judge	John W. Darrah	**Sitting Judge if Other than Assigned Judge**	
CASE NUMBER	04 C 2836	**DATE**	11/15/2004
CASE TITLE	HSBC Bank USA vs. UAL		

[In the following box (a) indicate the party filing the motion, e.g., plaintiff, defendant, 3rd party plaintiff, and (b) state briefly the nature of the motion being presented.]

MOTION:

DOCKET ENTRY:

(1) ☐ Filed motion of [use listing in "Motion" box above.]

(2) ☐ Brief in support of motion due ___.

(3) ☐ Answer brief to motion due ___. Reply to answer brief due ___.

(4) ☐ Ruling/Hearing on ___ set for ___ at ___.

(5) ☐ Status hearing [held/continued to] [set for/re-set for] on ___ set for ___ at ___.

(6) ☐ Pretrial conference [held/continued to] [set for/re-set for] on ___ set for ___ at ___.

(7) ☐ Trial [set for/re-set for] on ___ at ___.

(8) ☐ [Bench/Jury trial] [Hearing] held/continued to ___ at ___.

(9) ☐ This case is dismissed [with/without] prejudice and without costs [by/agreement/pursuant to]

☐ FRCP4(m) ☐ Local Rule 41.1
☐ FRCP41(a)(1) ☐ FRCP41(a)(2)

(10) ■ [Other docket entry] For the reasons stated in the attached memorandum opinion and order, the March 30, 2004, judgment of the bankruptcy court order, granting summary judgment in favor of United based on its finding that the facilities lease was not a true lease, is reversed. Enter Memorandum Opinion and Order.

(11) ■ [For further detail see order attached to the original minute order.]

	No notices required, advised in open court.	Filed Nov. 15, 2004	number of notices	Document Number
	No notices required.		NOV 16 2004 date docketed	20
	Notices mailed by judge's staff.		/s/ JTP docketing deputy initials	
	Notified counsel by telephone.		date mailed notice	
✓	Docketing to mail notices.		mailing deputy initials	
	Mail AO 450 form.			
	Copy to judge/magistrate judge.			
MF	courtroom deputy's initials	Date/time received in central Clerk's Office		

BEST AVAILABLE COPY

United States District Court, Northern District of Illinois

Name of Assigned Judge or Magistrate Judge	John W. Darrah	Sitting Judge if Other than Assigned Judge	
CASE NUMBER	04 C 2837	DATE	11/15/2004
CASE TITLE	UAL vs. California Statewide Communities Development Authority		

[In the following box (a) indicate the party filing the motion, e.g., plaintiff, defendant, 3rd party plaintiff, and (b) state briefly the nature of the motion being presented.]

MOTION:

DOCKET ENTRY:

(1) ☐ Filed motion of [use listing in "Motion" box above.]

(2) ☐ Brief in support of motion due ___.

(3) ☐ Answer brief to motion due ___. Reply to answer brief due ___.

(4) ☐ Ruling/Hearing on ___ set for ___ at ___.

(5) ☐ Status hearing [held/continued to] [set for/re-set for] on ___ set for ___ at ___.

(6) ☐ Pretrial conference [held/continued to] [set for/re-set for] on ___ set for ___ at ___.

(7) ☐ Trial [set for/re-set for] on ___ at ___.

(8) ☐ [Bench/Jury trial] [Hearing] held/continued to ___ at ___.

(9) ☐ This case is dismissed [with/without] prejudice and without costs [by/agreement/pursuant to]

☐ FRCP4(m) ☐ Local Rule 41.1

☐ FRCP41(a)(1) ☐ FRCP41(a)(2)

(10) ■ [Other docket entry] For the reasons stated in the attached memorandum opinion and order, the March 30, 2004, judgment of the bankruptcy court order, granting summary judgment in favor of United based on its finding that the facilities lease was not a true lease, is reversed. Enter Memorandum Opinion and Order. (Original opinion under case number, 04 C 2836, HSBC Bank USA v. UAL).

(11) ■ [For further detail see order attached to the original minute order.]

	No notices required, advised in open court.	Filed NOV. 15, 2004	number of notices	Document Number
	No notices required.		NOV 16 2004 date docketed	19
	Notices mailed by judge's staff.			
	Notified counsel by telephone.		/s/ [Illegible] docketing deputy initials	
✓	Docketing to mail notices.			
	Mail AO 450 form.		date mailed notice	
	Copy to judge/ magistrate judge.			
MF	court-room deputy's initials	Date/time received in central Clerk's Office	mailing deputy initials	

307 B.R. 618

United States Bankruptcy Court,
N.D. Illinois,
Eastern Division.
In re UAL CORPORATION, et al., Debtors.
United Air Lines, Inc., Plaintiff,
v.
HSC Bank USA, as trustee, the California Statewide Communities Development
Authority, the City and County of San Francisco, and the Airports Commission
for the City and County of San Francisco, Defendants.
United Air Lines, Inc., Plaintiff,
v.
The Bank of New York, Inc., as trustee, the Port Authority of New York and New
Jersey, and the New York City Industrial Development Agency, Defendants.
United Air Lines, Inc., Plaintiff,
v.
U.S. Bank N.A., as trustee, the Regional Airports Improvement Corporation, and
the City of Los Angeles, Defendants.
United Air Lines, Inc., Plaintiff,
v.
HSC Bank USA, as paying agent, and the City and County of Denver, Defendants.
Bankruptcy No. 02 B 48191.
Adversary Nos. 03 A 00975, 03 A 00976, 03 A 00977, 03 A 00978.

March 30, 2004.

James H.M. Sprayregen, Marc Kieselstein, David R. Seligman, Todd Gale, Kirkland & Ellis, Chicago, IL, for Debtors.

Ronald Barliant, Andrew Weissman, Goldberg, Kohn, Bell, Black, Rosenbloom & Moritz, Ltd., Chicago, IL; and Katherine A. Constantine, Steven J. Heim, Dorsey & Whitney, LLP, Minneapolis, MN; Mark J. Prager, Jill L. Murch, Foley & Lardner, Chicago, IL, for U.S. Bank National Association.

R. Dale Ginter, Sallie B. Armstrong, Jenna L. Clark, Downey Brand LLP, Sacramento, CA, for California Statewide Communities Development Authority.

Paul E. Chronis, Kristin L. Cantu, Hannah J. Mufson, Nathan F. Coco, McDermott, Will & Emery, Chicago, IL, for JFK.

Charles P. Schulman, Arlene Gelman, Sachnoff & Weaver, Ltd, Chicago, IL; John J. Bingham, Jr., Aaron E. DeLeest, David A. Gill, Danning, Gill, Diamond & Kollitz, LLP, Los Angeles, CA; Steven J. Heim, Patrick J. McLaughlin, Katharine A. Constantine, Dorsey & Whitney, LLP, Minneapolis, MN, for LAX and City of Los Angeles.

David A. Golin, Gesas, Pilati, Gesas & Golin, Ltd., Chicago, IL; Rockard J. Delgadillo, Eduardo Angeles, John M. Werlich, Office of the Los Angeles City Attorney, Los Angeles, CA, for The Regional Airports Improvement Corp.

William W. Kannel, Timothy J. Langella, George Hofman, Mintz, Levin, Cohen, Ferris, Glovsky & Popeo, PC, Boston, MA; Douglas W. Jessop, Kerstin Cass, Jessop & Company, P.C., Andrew M. Schauer, Krys Boyle, P.C., Denver, CO, for Denver Airport.

Gary W. Garner, Harold Kaplan, Mark F. Hebbeln, Stephanie Wickouski, Gardner, Carton & Douglas, Chicago, IL, for HSBC Bank USA.

Jason E. Rios, Dale R. Ginter, Downey Brand, LLP, Sacramento, CA, for California Statewide Communities.

Kirk Dillman, Michael Morris, Josh Mester, Hennigan, Bennett & Dorman, LLP, Los Angeles, CA, for HSBC Bank.

MEMORANDUM OF DECISION

EUGENE R. WEDOFF, Chief Judge.

Four related adversary proceedings are before the court in these jointly administered cases. In each of the proceedings, one of the debtors, United Air Lines, Inc. ("United"), seeks a declaratory judgment that certain of its payment obligations related to airport improvements are not obligations arising under "leases" pursuant to § 365 of the Bankruptcy Code (Title 11 U.S.C., the "Code"). The defendants in the proceedings are other parties to the instruments giving rise to the payment obligations. The defendants have all asserted that these instruments are in fact "leases" under § 365. Both United and the defendants seek summary judgment. As discussed below, a "lease" under § 365 must be a "true" lease, as opposed to a financing instrument. Because this is not the situation in three of the four adversary proceedings, United is entitled to summary judgment in those proceedings. In the fourth proceeding, involving the Denver airport, a true lease is involved, and the defendants are entitled to judgment.

Jurisdiction

Federal district courts have exclusive jurisdiction over bankruptcy cases. 28 U.S.C. § 1334(a). Pursuant to 28 U.S.C. § 157(a), district courts may refer bankruptcy cases

to the bankruptcy judges for their district, and, by Internal Operating Procedure 15(a), the District Court for the Northern District of Illinois has referred the pending cases. When presiding over a referred case, a bankruptcy judge has jurisdiction under 28 U.S.C. § 157(b)(1) to enter appropriate orders and judgments in core proceedings within the case. The pending adversary proceedings are core proceedings under 28 U.S.C. § 157(b)(2)(A) (matters concerning the administration of the estate), § 157(b)(2)(B) (allowance or disallowance of claims against the estate), § 157(b)(2)(M) (orders approving the use or lease of property), and § 157(b)(2)(O) ("other proceedings affecting . . . the adjustment of the debtor-creditor or equity security holder relationship"). *See In re PCH Assocs.*, 60 B.R. 870, 872-73 (S.D.N.Y.), *aff'd,* 804 F.2d 193 (2d Cir.1986) (declaratory judgment action to determine the "lease" status of an agreement is a core proceeding). This court therefore has jurisdiction to enter final orders with respect to the pending proceedings.

Undisputed Facts

The four adversary proceedings that produced the present motions all involve a similar situation: tax-exempt bonds were issued to finance the construction of airport improvements for the benefit of United, and the debt service on the bonds was to be paid with funds received from United. The parties dispute the effect in bankruptcy of the documents giving rise to United's payment obligations, but there is no dispute about the identity or content of these documents.

*1. **San Francisco International Airport (SFO) – Adversary Proceeding No. 03 A 00975.*** At the San

Francisco International Airport, United entered into a Ground Lease with the City and County of San Francisco, administered by their Airports Commission, on June 18, 1973 (the "SFO Ground Lease"). United was to use the leased land for "construction and operation of aircraft maintenance hangar, test and storage facilities" and for administrative and supervisory operations, rather than for loading and unloading commercial passengers and cargo. (SFO Ground Lease at 4-5.) The lease had an initial term of 20 years and was subject to two ten-year extensions at the option of United. (*Id.* at 7.) Thus, the lease would expire no later than 2113 [sic].

Some 24 years after the Ground Lease was executed, United, the California Statewide Communities Development Authority (a governmental agency authorized to issue bonds; the "CSCDA"), and an indenture trustee (now HSC Bank USA, the "SFO trustee") entered into four interrelated agreements, all dated August 1, 1997, in order to finance a number of improvements in United's facilities at the airport. The agreements included (1) a Site Sublease (the "SFO Sublease"), (2) a Facilities Lease (the "SFO Leaseback"), (3) an Indenture of Mortgage and Deed of Trust (the "SFO Indenture"), and (4) a Guaranty Agreement.

• *The SFO Sublease.* Pursuant to the SFO Sublease, United leased to the CSCDA a portion of the property covered by the SFO Ground Lease. (SFO Sublease at 2 and Exhibit A.) The term of the SFO Sublease is defined as the period from September 1, 1997 to October 5, 2033, unless a shorter or longer period (ending no later than October 5, 2038) is required to retire bonds to be issued by the CSCDA (with the parties expressly recognizing that the SFO Ground Lease might expire before the expiration of

the SFO Sublease). (*Id.* at 2.) The rent that the CSCDA was required to pay United for the entire term of the sublease was $1, and there is no provision for remedies on the part of United for any default by the CSCDA. (*Id.*)

• *The SFO Leaseback.* Under the SFO Leaseback, the CSCDA leased back to United the identical property leased to it in the SFO Sublease. (SFO Leaseback at 2.)[1] The term of the SFO Leaseback is also identical to the term of the SFO Sublease. (*Id.* at 3.) However, the rent United agreed to pay for leasing back the property that it subleased to the CSCDA is defined by the amounts necessary to make payments on the bonds to be issued under the SFO Indenture, together with the costs of administering the financing. (*Id.* at 3-4.)[2] The SFO Leaseback provides a full set of default provisions and remedies, including the CSCDA's right to take possession of the leased facilities and relet them if United fails to make the required payments. (*Id.* at 16-19.)

• *The SFO Indenture.* The SFO Indenture generally provides (a) for the issuance of tax-exempt bonds by the

[1] To see that the identical property is involved requires some effort. The SFO Leaseback defines its "Leased Facilities" as they are defined in the SFO Indenture. The SFO Indenture, in turn, defines "Leased Facilities" as the "Demised Premises and the improvements to be acquired, constructed . . . and installed thereon or therein." (SFO Indenture at 9.) The Indenture defines "Demised Premises" as the real property described in Exhibit A to the Indenture. (SFO Indenture at 6.) Exhibit A to the SFO Indenture is identical to Exhibit A to the SFO Sublease, which defines the property leased in that instrument.

[2] The SFO Leaseback requires United to pay as additional rent "Administrative Fees and Expenses." (SFO Leaseback at 4.) The SFO Indenture defines this term as "any administrative or other expenses incurred by the [CSCDA] or the Trustee" in connection with the SFO Sublease, Leaseback, or Indenture. (SFO Indenture at 5.)

CSCDA (SFO Indenture at 15, 37), (b) for the SFO trustee to receive the proceeds of the sale of the bonds for purposes of funding construction of defined improvements benefiting United (*id.* at 20-22), and (c) for the SFO trustee to receive the rental payments from United under the SFO Leaseback for the purpose of paying the debt service on the bonds and ultimately retiring them (*id.* at 29-33). The SFO Indenture makes clear that the bonds are "limited obligations" of the CSCDA, payable only from revenue received from United and earnings on this revenue. (*Id.* at 15.)

• *Guaranty Agreement.* The Guaranty Agreement sets out a guaranty from United to the SFO trustee of all payments due under the bonds.

2. ***JFK International Airport (JFK) – Adversary Proceeding No. 03 A 00976.*** At JFK International Airport in New York, United leases land from the Port Authority of New York and New Jersey (the "Port Authority") under an Agreement of Lease (the "JFK Ground Lease") dated August 1, 1995. The Port Authority's rights in the property derive from an "Agreement with respect to Municipal Air Terminals" between the Port Authority and the City of New York, dated April 17, 1947. The JFK Ground Lease involves premises consisting of two adjacent areas. (JFK Ground Lease at 2 and Exhibit A.) United was required to surrender one of the areas (Area II – referred to as Area 2 in the Exhibit and later agreements) no later than July 31, 1999. The lease on the other area (Area I – referred to as Area 1 in the Exhibit and later agreements) has an initial term expiring on December 30, 2015, subject to extension to July 31, 2024 if the Port Authority procures an extension of its lease with the City of New York. (*Id.* at 3.)

Within two years of the execution of the JFK Ground Lease, United, the Port Authority, the New York City Industrial Development Authority (a governmental agency authorized to issue bonds, the "NYCIDA"), and an indenture trustee (now the Bank of New York, Inc., the "JFK trustee") entered into a series of agreements to finance construction of a United cargo handling and warehousing facility and a ground service equipment facility at the airport. These agreements – all but the first of which are dated July 1, 1997 – include (1) a Company Sublease Agreement, dated January 1, 1997 (the "JFK Sublease"), (2) a Lease Agreement (the "JFK Leaseback"), (3) a Consent to Subleases Agreement (the "Consent Agreement"), (4) an Indenture of Trust (the "JFK Indenture"), (5) a First Supplemental Indenture of Trust (the "JFK Supplemental Indenture"), and (6) a Guaranty Agreement.

• *The JFK Sublease.* Pursuant to the JFK Sublease, United leased to the NYCIDA the "Facility Realty," consisting of Area 1 of the JFK Ground Lease. (JFK Sublease at 2, Indenture at 9.)[3] The term of the sublease has several variables, but will extend no longer than the maturity date of the bonds to be issued under the JFK Indenture (October 1, 2032). (*Id.*) The sublease also terminates with the expiration or earlier termination of the JFK Leaseback or the JFK Ground Lease. (*Id.* at 2-3.) The rental to be paid by the NYCIDA to United for the

[3] The JFK Sublease does not itself define the "Facility Realty" involved, but it does incorporate definitions of capitalized terms from the JFK Indenture. (JFK Sublease at 1). The Indenture, in turn, defines "Facility Realty" as the land described in its appendices (JFK Indenture at 9), and Appendix A to the Indenture describes the Facility Realty as Area 1 of the JFK Ground Lease, using the same drawing as in Exhibit A to the Ground Lease.

entire term of the sublease is $10, and there is no provision for remedies on the part of United for any default by the NYCIDA. (*Id.* at 4.)

• *The JFK Leaseback.* Under the JFK Leaseback, the NYCIDA leased back to United the identical property leased to it in the JFK Sublease. (JFK Leaseback at 15.) The term of the JFK Leaseback is also substantially identical to the term of the JFK Sublease. (*Id.* at 15-16.) However, the rent United pays for leasing back the property that it subleased to the NYCIDA is defined by the amounts necessary to make payments on the bonds to be issued under the JFK Indenture. (*Id.* at 17-18.)[4] The JFK Leaseback provides a set of default provisions and remedies, including the right on behalf of the NYCIDA (with the consent of the JFK trustee) to terminate United's interests in the subleased property if United fails to make the required payments, but not including a right to take possession of the leased facilities and relet them. (*Id.* at 39-43.)

• *The Consent Agreement.* In the Consent Agreement, the Port Authority consented to the JFK Sublease and Leaseback, with the proviso that "[t]he Subleases and the financing transaction of which the Subleases are a part . . . are expressly and in all respects subject and subordinate to . . . all of the terms . . . of the [JFK Ground Lease]." (Consent Agreement at 2-3.)

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[4] The JFK Indenture (at 59) provides for United to pay the expenses of administering the Indenture "as provided in the [JFK Leaseback]," but the JFK Leaseback itself does not appear to provide for such payment. This may be an inadvertent omission, since the JFK Leaseback (at 17) makes reference to payment of rent in a § 3.5 but does not actually include such a section.

• *The JFK Indenture and Supplemental Indenture.* The JFK Indenture and Supplemental Indenture generally provide (a) for the issuance of tax-exempt bonds by the NYCIDA (JFK Indenture at 22-32, JFK Supplemental Indenture at 1-13, 15-16), (b) for the JFK trustee to receive the proceeds of the sale of the bonds for purposes of funding construction of defined improvements benefiting United (JFK Indenture at 33-35, JFK Supplemental Indenture at 20-21), and (c) for the JFK trustee to receive the rental payments from United under the JFK Leaseback for the purpose of paying the debt service on the bonds and ultimately redeeming them (JFK Indenture at 35-42). The Indenture makes clear that the bonds are "limited obligations" of the NYCIDA, payable only from revenue received from United and earnings on this revenue. (JFK Indenture at 27-28, JFK Supplemental Indenture at 3.)

• *The Guaranty Agreement.* The Guaranty Agreement sets out a guaranty from United to the JFK trustee of all payments due under the bonds.

3. ***Los Angeles International Airport (LAX) – Adversary Proceeding No. 03 A 00977.*** United conducts terminal operations at Los Angeles International Airport (LAX) on property rented from the City of Los Angeles pursuant to a Terminal Facilities Lease (the "LAX Ground Lease") dated June 4, 1981. This lease anticipated that United would construct expanded terminal facilities with financing possibly provided by or through the Regional Airports Improvement Corporation, a governmental agency authorized to issue bonds (the "RAIC"). (LAX Ground Lease at 2, 13, 72.) The term of the lease, as amended, was to commence November 15, 1981 (or later, in the event of delayed City Council approval) and was to

extend for 40 years, subject to earlier termination at the time of the expiration of any long term tax-exempt bond financing. (LAX Ground Lease at 15.) On November 15, 1982, United, the City of Los Angeles, the RAIC, and an indenture trustee entered into a series of agreements to effectuate the anticipated financing, including: (1) a Partial Assignment of Terminal Facilities Lease (the "LAX Assignment"), (2) a Facilities Sublease (the "LAX Lease-back"), (3) a Contingent Lease Agreement, (4) an Indenture of Mortgage and Deed of Trust (the "LAX Indenture"), (5) a First Supplemental Indenture of Mortgage and Deed of Trust (the "LAX Supplemental Indenture"), and (6) a Guaranty Agreement.

• *The LAX Assignment.* In the LAX Assignment, United assigned to the RAIC all of United's right and interest in the LAX Ground Lease "as it relates and applies to the RAIC Facilities" – the facilities that would be constructed with the financing to be obtained through the RAIC. (LAX Assignment at 2 and Exhibit A.) The only consideration stated for this assignment is "the agreements and undertakings by the parties hereto." (*Id.* at 2.) The LAX Assignment terminates upon termination of the LAX Leaseback. (*Id.*)

• *The LAX Leaseback.* In the LAX Leaseback, the RAIC leased back to United the right and interest in the RAIC Facilities that the RAIC received through the LAX Assignment. (LAX Leaseback at 1-2, 5.) The term of the LAX Leaseback commenced on November 15, 1982 and extends "until payment or redemption of the Bonds" to be issued under the LAX Indenture and Supplemental Indenture. (*Id.* at 3.) The rent to be paid by United for leasing back the right and interest that it assigned to the RAIC is defined as the amounts necessary to make

payments on the bonds to be issued under the LAX Indenture together with RAIC's expenses of administering the financing project. (*Id.* at 4-5.) The LAX Leaseback contains a full set of default and remedy provisions, including an authorization for the RAIC to remove United from the RAIC Facilities in the event of default and to "make efforts to relet the RAIC Facilities." (*Id.* at 19-23.)

• *The Contingent Lease Agreement.* The Contingent Lease Agreement effectuated the RAIC's rights in the event of a default by United under the LAX Leaseback. The agreement provides that, in the event that United's rights under the LAX Leaseback are terminated because of United's default, the City of Los Angeles will grant the RAIC a 90-day option to enter into a new Ground Lease, on the same terms offered to United, for the balance of the remaining term of the Ground Lease. (Contingent Lease Agreement at § 1.)

• *The LAX Indenture and Supplemental Indenture.* The LAX Indenture and Supplemental Indenture generally provide (a) for the issuance of tax-exempt bonds by the RAIC (LAX Indenture at 1, 13-20; LAX Supplemental Indenture at 1, 3-4), (b) for the LAX trustee to receive the proceeds of the sale of the bonds for purposes of funding construction of the RAIC Facilities (LAX Indenture at 22, LAX Supplemental Indenture at 6), and (c) for the LAX trustee to receive the rental payments from United under the LAX Leaseback (either directly from United or from RAIC within one day of RAIC's receipt of the payment from United) for the purpose of paying the debt service on the bonds and ultimately redeeming them (LAX Indenture at 31-36). The bonds issued under the Indentures are to be "payable both as to principal and interest, and premium, if any, from the Revenues to be derived by the [RAIC] from

the lease [back] of the RAIC Facilities to [United] . . . and from amounts received by the [Indenture] Trustee from UAL, Inc . . . . pursuant to [the] Guaranty Agreement." (LAX Indenture at 93, LAX Supplemental Indenture at C-2.)

• *The Guaranty Agreement.* The LAX Guaranty Agreement sets out a guaranty from UAL, Inc., the parent of United (and a debtor in one of the related bankruptcy cases) to the indenture trustee of all payments due under the bonds issued pursuant to the LAX Indenture. The guaranty does not address United's obligations under the LAX leaseback.

The bonds issued pursuant to the LAX Indenture and Supplemental Indenture were redeemed by subsequent bond issues, pursuant to further supplemental indentures, for which U.S. Bank N.A. serves as indenture trustee. The later indentures incorporate the terms of the original LAX Indenture relevant to the present dispute.

4. Denver International Airport (DEN) – Adversary Proceeding No. 03 A 00978. At the Denver International Airport, the financing of improvements for United was accomplished by three documents: (a) a "Special Facilities and Ground Lease" (the "Denver Lease"), dated October 1, 1992, (b) an ordinance of the City of Denver, Ordinance No. 712, approved on October 14, 1992 (the "Ordinance"), and (c) a Guaranty of United, dated October 1, 1992.

• *The Denver Lease.* The Denver Lease conveys rights to United in two distinct sets of property: (1) about 45 acres of real property (described in Exhibit B to the Denver Lease), and (2) a number of "facilities," including buildings, fixtures, and personal property (set out in

Exhibit A), whose purchase and construction were to be financed through bonds issued by the City of Denver. (*Id.* at 1-2, 7-8, 15-16.) United's obligations to pay rent under the lease have two components: (1) "Ground Rentals," payable monthly, based on a rate per square foot plus costs for common use services, and (2) "Facilities Rentals," payable at the times and in the amounts necessary for debt service on the bonds through which the facilities are financed. (*Id.* at 20-21.) Failure by United to make payment of either type of rent is an event of default, which may result in termination of the lease and removal of United from possession. (*Id.* at 45-47.)

• *The Ordinance.* The Ordinance provides (a) for the issuance and sale of tax exempt bonds by the City (Ordinance at 10-11; Exhibit A at A-5), (b) for a "paying agent" (now HSC Bank USA) to receive the proceeds of the sale of the bonds for purposes of funding construction of the facilities (*id.* at 15-16), and (c) for the paying agent to receive the Facilities Rentals from United under the Denver Lease for the purpose of debt service on the bonds and their ultimate redemption (*id.* at 18). The bonds issued under the Ordinance are "payable solely from the Facilities Rentals payable under the Lease and amounts payable under the Guaranty." (*Id.* at 2, Exhibit A at A-2.)

• *The Guaranty.* The Guaranty sets out a guaranty from United to the paying agent of all payments due under the bonds issued pursuant to the Ordinance.

United and twenty-seven related corporations filed the pending Chapter 11 cases in December 2002. In March 2003, United filed the pending adversary proceedings. Each seeks a declaratory judgment that United's obligations to make payments on account of the outstanding

bond issues do not arise under "leases," but rather that the documents outlined above constitute "disguised financing arrangements." In each adversary, the defendants answered and counterclaimed for a declaration that the payment obligations in question did arise under leases. The parties engaged in discovery and then filed, briefed, and argued the cross-motions for summary judgment now pending.

Legal Discussion

Summary judgment is appropriate where the pleadings, affidavits, and other materials on file demonstrate that there exists no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. Fed.R.Civ.P. 56(c), incorporated into Fed. R. Bankr.P. 7056; *Massachusetts Bay Ins. Co. v. Vic Koenig Leasing, Inc.*, 136 F.3d 1116, 1119-20 (7th Cir.1998). There are no material facts in dispute in these proceedings.

The significance of a "lease" in bankruptcy. There are a variety of financial arrangements in which one party occupies real property while making payments to another party which has an interest in the property. The two most common are mortgages and leases, and in many respects they are similar. In both, the party occupying the property, the mortgagor or lessee, has an obligation to make periodic payments to the other party, the mortgagee or lessor. And in both, the consequence of a default in the required payments is a loss of occupancy rights, either through foreclosure or eviction. But in other respects, and particularly under the Bankruptcy Code, the two situations are quite different.

If a Chapter 11 debtor occupies non-residential real property as owner under a mortgage, the debtor may retain the property by paying the mortgagee no more than the current value of the property, with any additional amounts owing on the mortgage treated as an unsecured claim, pursuant to §§ 506(a) and 1129(b)(2)(A) of the Code. *In re Smith*, 287 B.R. 882, 884 (Bankr.W.D.Tex.2002). On the other hand, if the debtor does not retain the property, the mortgagee is entitled under § 506(a) of the Code to an unsecured claim for the full difference between the amounts due on the mortgage at the time of the filing and the property value.

However, if the debtor holds the property as tenant under a lease, the situation is governed by § 365 of the Code, under which the debtor may retain its occupancy and other rights only by "assuming" the lease. Lease assumption requires that the debtor cure any defaults that occurred before the bankruptcy, maintain payment obligations during the bankruptcy, and give assurance that there will be no defaults in future payment obligations. *In re Resource Technology Corp.*, 254 B.R. 215, 221 (Bankr.N.D.Ill.2000). On the other hand, if the debtor surrenders the property and rejects the lease, the landlord is entitled to an unsecured claim as limited by § 502(b)(6) of the Code, which may be less than the balance due under the lease.

In this way, the Bankruptcy Code gives greater protection to the occupancy rights of the owner of leased property than to the occupancy rights of a lender on mortgaged property, but it gives less protection to the owner's total claim. The owner of leased property is denied repossession only if the debtor makes full payment under the lease, but the owner may receive a claim for less than

the full amount due under the lease if the debtor surrenders the property; the lender on mortgaged property will be denied repossession if the debtor merely pays the lender's claim up to the value of the property, but the lender receives an unsecured claim in the full amount of any deficiency.

At the four airports involved in the pending adversary proceedings, United occupies property under agreements calling for it to make periodic payments used for debt service on tax-exempt bonds. As set out above, the agreements for each airport property are denominated "leases." United brought the pending adversary proceedings seeking a declaratory judgment that the agreements should not be treated as leases under § 365, with the potential effect of allowing United to retain its occupancy without lease assumption.

The meaning of "lease" under § 365. The term "lease" is not defined in the Bankruptcy Code. *See In re Resource Technology Corp.*, 254 B.R. at 225-26 (distinguishing between leases and other executory contracts). However, the decisions construing § 365 of the Code uniformly hold that the simple employment of the word "lease" does not bring every agreement calling itself a lease within that section. This understanding is necessary to avoid absurd results. The simplest home mortgage could be called a "lease," with the down payment called a "security deposit," the monthly payments of principal and interest called "rent," and the "tenant" provided with a title to the property after a 30-year "lease term." Rather than allowing such manipulation of terminology to control the results in bankruptcy, courts look to the economic reality underlying a questioned agreement. *Liona Corp. v. PCH Assocs. (In re PCH Assocs.)*, 804 F.2d 193, 198 (2d

Cir.1986) ("We interpret section 365(d)(3), (4) of the Bankruptcy Code to apply solely to a 'true' or 'bona fide' lease."); *City of San Francisco Market Corp. v. Walsh (In re Moreggia & Sons, Inc.)*, 852 F.2d 1179, 1183 (9th Cir.1988) ("[W]e have . . . declined to require assumption or rejection of a purported lease that is in substance a security agreement, even where the agreement has taken on the surface formalities of a contract or unexpired lease that might otherwise come within the reach of section 365."); *City of Olathe v. KAR Dev. Assocs., L.P. (In re KAR Dev. Assocs., L.P.)*, 180 B.R. 629, 636 (D.Kan.1995) ("[T]his court is persuaded that Congress intended § 365(d)(4) to apply only to 'true' or bona fide' leases . . . "); *Marriott Family Restaurants, Inc. v. Lunan Family Restaurants (In re Lunan Family Restaurants)*, 194 B.R. 429, 450 (Bankr.N.D.Ill.1996) ("Labeling an agreement a 'lease' does not make it one.").

This limitation of § 365 to true leases is well grounded. Before the adoption of the Bankruptcy Code in 1978, a distinction had become firmly established in the context of statutes regulating economic activity between "true" leases and financing arrangements "disguised" as leases. Since at least *Helvering v. F & R Lazarus & Co.*, 308 U.S. 252, 60 S.Ct. 209, 84 L.Ed. 226 (1939), federal tax law has treated as leases only those agreements that function as true leases in an economic sense.[5] In *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S.Ct. 1291, 55

[5] *Lazarus* allowed a taxpayer to claim a depreciation deduction on property that the taxpayer had nominally sold to a bank and leased back from the bank, upon a finding that "the transaction . . . was actually a loan secured by the property involved." 308 U.S. at 255, 60 S.Ct. 209.

L.Ed.2d 550 (1978), decided while Congress was considering the legislation giving rise to the Bankruptcy Code, the Supreme Court affirmed that, for purposes of tax law, "courts are concerned with substance and realities, and formal written documents are not rigidly binding," *id.* at 573, 98 S.Ct. 1291, so that the Court would not condone "manipulation by a taxpayer through arbitrary labels and dealings that have no economic significance," *id.* at 583, 98 S.Ct. 1291. Thus, the Court ruled, a taxpayer can safely treat leases as genuine for tax purposes only if the taxpayer "retains significant and genuine attributes of the traditional lessor status." *Id.* at 584, 98 S.Ct. 1291.

Similarly, the Uniform Commercial Code ("UCC"), widely adopted during the 1960s, defined "security interest" as including financing agreements in the form of personal property leases. Section 1-201(37) of the 1958 Official Text of the UCC provided, in part:

> Unless a lease . . . is intended as security, reservation of title thereunder is not a "security interest" . . . Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.

By the 1970s, this provision had generated considerable litigation and academic commentary, with particular emphasis on the interests of claimants in bankruptcy. *See, e.g., Feldman v. First National City Bank (In re Leasing*

Consultants, Inc.), 486 F.2d 367, 372 (2d Cir.1973) (holding, in a reclamation action against a bankruptcy trustee, that "the determination of whether the lease instruments were 'true leases' or security agreements is critical."); *DeVita Fruit Co. v. FCA Leasing Corp. (In re DeVita Fruit Co.)*, 473 F.2d 585, 589 (6th Cir.1973) (holding that the question of whether a bankruptcy trustee or a putative lessor was entitled to the proceeds of an equipment sale depended on whether a true lease was involved: "When the lease is intended as a security interest, Article 9 applies .... However, a bona fide lease is not affected by Article 9."); Louis F. Del Duca, *Evolving Standards for Distinguishing a "Bona Fide Lease" from a "Lease Intended as Security" – Impact on Priorities*, 75 Com. L.J. 218 (1970); William B. Davenport & Daniel R. Murray, *Secured Transactions* § 2.04(a) (1978):

> [A] considerable number of agreements called leases are really disguised conditional sales and will be held to be such if they are questioned in appropriate litigation ....
>
> ....
>
> Under the 1962 Text of Article 9, it is important to determine whether the transaction is one intended as security because filing is required to perfect the security interest of the lessor-secured party. In the absence of proper filing, the unperfected security interest will be subordinate to ... the rights of lien creditors (including a trustee in bankruptcy) ....

With these principles of economic regulation well established, it is highly likely that in creating special treatment for "leases" in § 365 of the Bankruptcy Code, Congress intended to include only economically "true" leases – and the legislative history confirms this. In

discussing the language now found at § 502(b)(6), limiting damages resulting from rejection of a lease under § 365, the Senate Report restricts the Code's "lease" treatment to true leases and incorporates the concepts underlying the UCC's definition of "security interest":

> [T]he phrase 'lease of real property' applies only to a 'true' or 'bona fide' lease and does not apply to financing leases of real property or interests therein, or to leases of such property which are intended as security.
>
> [I]n a true lease of real property, the lessor retains all risk and benefits as to the value of the real estate at the termination of the lease . . .
>
> Whether a "lease" is [a] true or bona fide lease or, in the alternative, a financing "lease" or a lease intended as security, depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not, for example, upon the locus of title, the form of the transaction, or the fact that the transaction is denominated as a "lease". The fact that the lessee, upon compliance with the terms of the lease, becomes or has the option to become the owner of the leased property for no additional consideration or for nominal consideration indicates that the transaction is a financing lease or lease intended as security. In such cases, the lessor has no substantial interest in the leased property at the expiration of the lease term. In addition, the fact that the lessee assumes and discharges substantially all the risks and obligations ordinarily attributed to the outright ownership of the property is more indicative of a financing transaction than of a true lease. The rental payments in such cases are in substance payments of principal and interest either on a loan

> secured by the leased real property or on the purchase of the leased real property.

S.Rep. No. 989, 95th Cong., 2d Sess. 64 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5850.

Thus, just as the term is understood in federal tax law and under the UCC, "lease" in § 365 of the Bankruptcy Code means "true lease."[6]

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[6] Some cases suggest that state law determines the kind of real estate "lease" that is subject to assumption or rejection under § 365. *See, e.g., Martin Bros. Toolmakers, Inc. v. Industrial Dev. Bd. (In re Martin Bros. Toolmakers, Inc.)*, 796 F.2d 1435, 1440 (11th Cir.1986) (citing Alabama law in determining "not to pursue a bankruptcy law analysis" of whether a true lease was involved); *Fox v. Peck Iron & Metal Co.*, 25 B.R. 674, 688-90 (Bankr.S.D.Cal.1982) (relying on California law to determine that a sale/leaseback did not involve a true lease). It has been argued that Congress intended state law to control, based on the legislative history of the definition of "security interest" (now in § 101(51) of the Code): "A security interest is . . . a lien created by an agreement. . . . Whether a . . . lease constitutes a security interest under the bankruptcy code will depend on whether it constitutes a security interest under applicable State or local law." S.Rep. No. 989, 2d Sess. 26 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5812. This statement, however, does not contradict those portions of the same report indicating that §§ 365 and 502(b)(6) apply only to true leases. Compliance with local law is necessary to create the lien that gives rise to any security interest. As a result, to be considered a security interest under the Bankruptcy Code, a lease must constitute a lien under local law. It is certainly possible for a given agreement to fall outside the coverage of § 365, because it is not a true lease, and also fail to confer a "security interest" because the requirements of local law for creation of a lien have not been satisfied. Because the Bankruptcy Code itself uses "lease" in § 365 to mean a true lease, state law should not be used to reach a contrary result. *See Perez v. Campbell*, 402 U.S. 637, 652-53, 91 S.Ct. 1704, 29 L.Ed.2d 233 (1971) (holding in a bankruptcy context that "any state legislation which frustrates the full effectiveness of federal law is rendered invalid by the Supremacy Clause").

The standards for determining a true lease. According to the language of the Senate Report on the Bankruptcy Code, and consistent with the legal standards developed under the UCC and federal tax law, a "lease" under § 365 of the Bankruptcy Code requires that the lessor retain significant "risk and benefits as to the value of the [putatively leased] real estate at the termination of the lease." The Supreme Court emphasized risk to the lessor, including "all building depreciation risks," in finding a true lease for tax purposes in *Frank Lyon Co.*, 435 U.S. at 582-83, 98 S.Ct. 1291. And the need for a true lessor to retain risk at lease termination is reflected in the UCC's prescription that a true lease does not exist where "upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration." In such a situation, the lessee has effectively purchased the property through the mechanism of the lease, and so the lessee, not the lessor, has the benefit or burden of changes in the value of the property when the lease terminates. Similarly, if the lease lasts for the economic life of the property being leased, the lessee, not the lessor, bears the risk of changes in value. This is because the lessee will be paying a fixed amount to the lessor for whatever value the property has during its economic life, with the lessor having no risk other than nonpayment (the same risk that any secured lender bears).[7]

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[7] The UCC definition of "security interest" was amended to state expressly that a transaction denominated a lease is a financing agreement (rather than a true lease) "if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee; and . . . the original term of the lease is equal to or greater than

(Continued on following page)

Beyond this central issue – how a questioned lease allocates ownership risk – courts determining the status of a lease for purposes of § 365 have considered a variety of factors ordinarily associated with ownership rather than lessor status. The most frequently cited list is in *Hotel Syracuse, Inc. v. City of Syracuse Indus. Dev. Agency (In re Hotel Syracuse, Inc.)*, 155 B.R. 824, 838 (Bankr.N.D.N.Y.1993), *citing PCH Assocs.*, 804 F.2d at 200-01:

> (i) whether the "rental" payments were calculated to compensate the lessor for the use of the land, or rather were structured for some other purpose, such as to ensure a particular return on an investment;
>
> (ii) whether the [lessor's] purchase price was related to the fair market value of the land, or whether it was calculated as the amount necessary to finance the transaction;
>
> (iii) whether the property was purchased by the lessor specifically for the lessee's use;
>
> (iv) whether the transaction was structured as a lease to secure certain tax advantages;
>
> (v) whether the lessee assumed many of the obligations normally associated with outright ownership, including the responsibility for paying property taxes and insurance.

In applying the standards for determination of a true lease to the leases in question here, it is helpful to divide the leases into two categories: in the first category are the

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the remaining economic life of the goods." UCC § 1-201(37)(b) (1987). The current version of Article 1 [sic] the UCC sets out the same definition in § 1-203(b)(1) (2001).

three leases (SFO, JFK, and LAX) involved in lease/leaseback transactions: in the second category is the single lease (DEN) not involved in such a lease/leaseback.

The lease/leaseback transactions: financing arrangements. The transactions described above involving San Francisco, JFK, and Los Angeles International Airports all have a common feature: a bond-issuing agency received an interest in a leasehold held by United and leased that interest back to United in exchange for rent equaling the debt service and administrative costs associated with bonds issued by the agency, with a lease term ending with final payment of the bonds. United is correct in contending that these leaseback transactions are not true leases subject to assumption or rejection under § 365, as is apparent from three distinct considerations.

First, and most important, the status of the three leasebacks is governed by the principle that there cannot be a true lease where the lessor has no ownership interest at the end of the lease term. Here, the bond-issuing agencies have no such ownership interest because the property interest they are leasing to United is itself a leasehold that terminates at the end of the term of the leaseback. In each of the leaseback arrangements, United transferred to the agency (either by sublease or assignment) a leasehold interest in airport property that United held under a ground lease from the operator of the airport, and in the leasebacks the agencies transferred the identical interest to United. Each of the leaseback arrangements has the following defining features:

- United has no right to terminate the leaseback before the redemption of the bonds issued by the agency for United's benefit;

• the leasehold interest transferred from United and the leaseback of that interest to United both have the same term, coinciding with the redemption of bonds; and

• the rent payable by United exactly equals the debt service and administrative expenses connected to the bond issues.

Thus, unlike a true lease – where the leased property reverts to the lessor at the end of the lease term with substantial value remaining, as to which the lessor takes the ownership risk – the leasebacks terminate with no property interest reverting to the bond-issuing agencies.[8] Since the leasehold that is the subject of each leaseback expires during the term of the leaseback, its entire economic value is exhausted during the leaseback, and nothing reverts to the agencies.

The agencies, trustees, and airport operators dispute this, observing that the airport property involved in United's ground leases retains value after the termination of the leasebacks. Though accurate, this observation does not affect the ownership analysis. The airport property itself was not leased back; only a leasehold interest in that property was, and that leasehold does not survive the end of the term of the leasebacks. The absence of a surviving ownership interest dictates a determination that the leasebacks are not true leases.

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[8] Of course, if the leaseback terminated prematurely because of a default by United, the agency might assert an interest in the leasehold, but this sort of interest – active only on default – is a hallmark of secured financing, not true leasing. The test for a true lease is the interest reverting to the lessor, in the absence of default, at the end of the stated term of the lease.

Second, the *Syracuse Hotel* factors, to the extent that each is relevant, confirm this determination.

(i) The rental payments from United under the leasebacks were not calculated to compensate the agencies for the use of the transferred leasehold, but were defined by the amounts needed to pay the bonds. It may be that the periodic payments on the bonds required under the leasebacks approximated the fair rental value of the property interests conveyed by the leasebacks, but the bond payments – not the use values of the property – were controlling. This is evident from the result under the leasebacks in situations where the value of the leasehold is reduced: (1) if United makes sufficient payments to redeem the bonds early, the leasebacks terminate immediately, with no reduction in rental payments by United corresponding to the shorter lease term; and (2) if a portion of the property involved in the leasebacks is lost through condemnation, there is again no diminution of the leaseback rent.[9]

(ii) The agencies did not acquire the interests that they leased back to United for market value. Rather, they paid nominal (if any) consideration to United, and the real consideration for the leaseholds transferred by United was the promise by the agencies to issue bonds on United's behalf.

(iii) The property interest involved in the leasebacks (the leasehold interest under the ground leases) was acquired by the agencies specifically for United's use.

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[9] SFO Leaseback at 5, LAX Leaseback at 5-6, and JFK Leaseback at 25.

(iv) The leases were part of an arrangement structured to obtain tax advantages (although tax exempt bonds might have been issued without leasebacks, as was done in the situation of the Denver International Airport).

(v) The lessee (United) had all of the ordinary obligations associated with ownership, including the need to maintain insurance and pay property taxes.

Finally, the leaseback transactions at issue here are the economic equivalent of leasehold mortgages, a recognized real estate financing mechanism – again supporting the conclusion that the leasebacks are financing arrangements. *See* Grant S. Nelson & Dale A. Whitman, *Real Estate Finance Law* § 15.14 (4th ed.2002).[10] In a typical leasehold mortgage, a lender receives a lien on the debtor's leasehold interest, and in the event of default on the loan, the lender may terminate the debtor's rights in the mortgaged lease. Then, the lender may either occupy the real estate or re-lease it to another party. The leasebacks here have the same effect: United, as the "owner" of the leasehold created by its ground leases, effectively mortgaged a portion of its leasehold interest as security for the bond payments. As long as United pays the "rent" equaling debt

[10] "A leasehold mortgage is a security interest in the lessee's rights and interests under a ground lease, including the lessee's leasehold estate in the leased premises. A leasehold mortgage ordinarily also encumbers any buildings and other improvements not included in the leased premises, but owned by the lessee. Although the typical leasehold mortgage secures a lessee-borrower's obligation to repay a loan, a leasehold mortgage may be given as security for the performance of any obligation capable of being secured by a mortgage or security interest under applicable state law." Richard F. Casher et al., *Leasehold Mortgages in Bankruptcy: Look Before You Leasehold*, 402 PLI/Real 689, 697 (1993).

service on the bonds, it retains its full rights under ground leases. If it repays the bonds in full, the lease/leaseback ends, and the agencies have no further claim on the leasehold. But if United defaults, the agencies may accelerate the rental payments and (as to two of the leasebacks) terminate United's possession and relet the property.[11]

Indeed, lease/leaseback arrangements have been recommended as a financing alternative to leasehold mortgages, with the pointed caveat that "[b]ankruptcy courts tend to focus on the economic substance of a transaction and not the nomenclature that the parties to the deal have used" so that a court may "recharacterize the lease/leaseback transaction as a secured loan rather than an operating lease." *See* Kathi W. Borkholder, *Ground Leases-Lease/Leaseback Financing Alternatives to Mortgages,* 13-FEB Prob. & Prop. 37, 41 (1999). In what appears to be the only reported opinion considering the question, *Scottsdale Assocs., Inc. v. Seatrain Lines, Inc. (In re Seatrain Lines, Inc.),* 20 B.R. 577, 582 (Bankr.S.D.N.Y.1982), the court recharacterized a lease/leaseback arrangement as a form of mortgage. Recharacterization is similarly required here; United has overcome the presumption that the terminology used by the parties accurately reflected the economic substance of their

[11] The SFO and LAX Leasebacks, and SFO and LAX Indentures provide for this remedy. (SFO Leaseback at 15-17, SFO Indenture at 40-41, LAX Leaseback at 21, and LAX Indenture at 54-55.) The JFK Leaseback does not. (JFK Leaseback at 40-42.)

agreements. *See In re PCH Assocs.*, 804 F.2d at 200 (recognizing presumption and finding that it was overcome).[12]

Other arguments of the leaseback defendants. Two arguments remain to be considered in connection with the leasebacks. First, the LAX trustee argues that the court must consider the LAX Leaseback together with the LAX Ground Lease in determining its status as a true lease under § 365. In other words, the LAX trustee asserts that the two documents should be integrated into a single agreement. Since no provision of the Bankruptcy Code deals with the integration of agreements, this is an issue to be determined under applicable nonbankruptcy law, here the law of California. *Moore v. Pollock (In re Pollock),* 139 B.R. 938, 940 (9th Cir. BAP 1992). The factors relevant to that determination are: "(1) [w]hether the nature and purpose of the obligations are different; (2) whether the consideration for the obligations is separate and distinct; and (3) whether obligations of the parties are interrelated." *Id.*, at 940-41 (citing *In re Gardinier,* 831 F.2d 974, 976 (11th Cir.1987)).

These factors establish that the LAX Leaseback is not integral to the LAX Ground Lease. First, the purposes of the two agreements are different. The ground lease (LAX Ground Lease § 3, pp. 3-12) involves United's overall airport operations, covering a wide range of necessary facilities. Although it contemplates RAIC bonding, it also provides for financing from other sources (*id.* at § 4A, p. 12) and so is independent of any financing that RAIC

---

[12] However, no finding is made as to whether the leasebacks have met the requirements of local law for an enforceable leasehold mortgage.

might effectuate. The leaseback, on the other hand, covers only the facilities affected by the RAIC bond financing, and is intended to support repayment of the bonds. Second, the consideration for the two agreements is separate, with rent under the ground lease (*id.* at § 6, pp. 16-25) in no way connected to the leaseback rent, which is defined by the debt service on the bonds. And third, the obligations of the parties are distinct: United has separate payment obligations under the ground lease and leaseback; the City of Los Angeles has traditional duties of a lessor under the ground lease; and RAIC has no significant duties under the leaseback. The rest of the leaseback defendants have conceded that their agreements respecting United's bond financing are not subject to integration with the ground leases.

The other argument that various defendants advance is a quasi-estoppel claim – that because United treated the leasebacks as leases for purposes of accounting and for obtaining financing and tax benefits, United should not now be allowed to deny that the leasebacks are true leases under § 365 of the Bankruptcy Code. To some extent, these arguments are grounded in *Martin Bros. Toolmakers,* 796 F.2d at 1440, which employs state law to determine the status of a lease under § 365. As discussed above, this view is not adopted here. Furthermore, to the extent that the defendants are asserting a claim of equitable estoppel, it has no basis: they have pointed to no false statement of fact by United that they have relied on to their detriment. *See Hotel Syracuse,* 155 B.R. at 836 (discussing the elements of estoppel in connection with a determination of lease status under § 365). To refer to the leasebacks as leases is no misstatement, since that is their form, and the tax and accounting treatment properly accorded to the

leasebacks presents issues separate from the bankruptcy question involved here.[13] And regardless of the appropriateness of United's tax and accounting treatment of the leasebacks, these issues do not present factual matters on which the defendants could reasonably have relied. The defendants, all represented by counsel in connection with the negotiation of these complex agreements, were responsible for drawing their own conclusions about the legal impact of the leasebacks in bankruptcy.

The Denver Lease: a true lease. The Denver Lease is substantially different from the leasebacks discussed above. Unlike the bond-issuing agencies who were the nominal lessors in the leasebacks, the City of Denver unquestionably occupies a traditional lessor's position under the Denver Lease. It owns the leased property, and at the conclusion of the lease term it will receive the return of the property, with a substantial part of its economic life remaining. The City bears a genuine risk of changes in the property value at the end of the lease term. Recognizing that the lease, taken as a whole, is a true lease subject to assumption or rejection under § 365, United has argued that the lease should be severed into two agreements: one (a true lease) governing its use of the

[13] The Supreme Court recognized in *Frank Lyon* that the treatment of an agreement for purposes of tax law might be different from its treatment in other contexts: "[W]e are mindful that the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same." 435 U.S. at 577, 98 S.Ct. 1291; *accord Thor Power Tool Co. v. C.I.R.*, 439 U.S. 522, 541, 99 S.Ct. 773, 58 L.Ed.2d 785 (1979). Similarly, the treatment of a lease may be different under § 365 than in non-bankruptcy contexts.

airport real estate and another (a financing arrangement) providing for its repayment of bonds issued by the City.

Like the question of contract integration discussed above, the question of contract severability must be determined under applicable nonbankruptcy law, since the Bankruptcy Code does not address the issue. *In re Cafeteria Operators, L.P.*, 299 B.R. 384, 389 (Bankr.N.D.Tex.2003) (collecting authorities). By its terms, the Denver Lease is to be interpreted according to the law of Colorado. (Denver Lease § 12.11, p. 53.) A recent decision of the Colorado Supreme Court applies Colorado's rule for contract severability. In *Univex Int'l, Inc. v. Orix Credit Alliance, Inc.*, 914 P.2d 1355 (Colo.1996), the court dealt with a claim by a would-be purchaser of equipment under an oral contract to be financed by the seller. The purchaser sought application of a liberal statute of frauds under Article 2 of the Uniform Commercial Code, rather than the more stringent statute of frauds governing financing agreements, on the ground that there were two separate contracts involved: one for the sale of goods, the other for financing. The court rejected this argument, holding that "under Colorado law, a contract cannot be severed unless the language of the contract manifests each party's intent to treat the contract as divisible." *Id.* at 1357.

Nothing in the Denver Lease manifests an intent either by the City of Denver or by United to treat the lease as divisible into separate ground lease and financing components. United's principal argument in favor of severability is that its payment of the "Facilities Rentals" (the payments on account of the bonds issued by the City) is to be made to the paying agent for the bondholders rather than to the City. (Denver Lease, § 6.1, p. 20.) This, however, is no indication that the parties considered that

payment obligation severable from the rest of the lease. To the contrary, the lease provides that United's payments to the paying agent are "for the account of" the City (*id.* § 6.1(a), p. 20), and the lease treats a failure by United to make "Facilities Rentals" (bond) payments (*id.* § 11.1(a), p. 45) as an event of default equivalent to a failure to make any other payment required under the lease (*id.* § 11.1(b)). The City's major remedies on default draw no distinction between the various payment obligations. (*Id.*, § 11.2(a), (c), and (d), pp. 46-48.) In the absence of an indication of the parties' intent that the lease be severable, Colorado law requires that it be treated as an integrated, single agreement.[14] And because the Denver Lease, taken as a whole, is a true lease for purposes of § 365, it is not necessary to address the arguments of the parties as to whether the financing aspects of the lease, considered separately, would have that status.

Conclusion

For the reasons set out above, in Adversary Proceeding Nos. 03 A 00975, 03 A00976, and 03 A 00977, United's motions for summary judgement are granted and the defendants' motions for summary judgment are denied. In Adversary Proceeding No. 03 A 00978, the defendants' motion for summary judgment is granted and United's

[14] In determining severability for purposes of assumption or rejection under § 365, a bankruptcy court applying the law of the District of Columbia came to a similar conclusion, holding that a lease incorporating financing by the lessor could not be divided into separate lease and financing contracts. *In re Cafe Partners / Washington 1983*, 90 B.R. 1 (Bankr.D.D.C.1988).

mc[illegible] for summary judgment is denied. Separate orders wil[illegible] entered to that effect.

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

In re:	Chapter 11
UAL Corporation, et al., Debtors.	Case No. 02 B 48191
United Air Lines, Inc., Plaintiff, v. HSC Bank USA, as trustee, the California Statewide Communities Development Authority, the City and County of San Francisco, and the Airports Commission for the City and County of San Francisco, Defendants.	Adversary Proceeding No. 03 A 00975

JUDGMENT ORDER

This proceeding has come before the court on a motion for summary judgment on behalf of United Air Lines, Inc. ("United"), seeking a declaratory judgment that certain of its obligations to make payments related to airport improvements are not obligations arising under a "lease" pursuant to § 365 of the Bankruptcy Code (Title 11 U.S.C.). HSBC Bank USA, as Trustee, the California Communities Development Authority, and the City and County of San Francisco (the "Defendants") have filed cross-motions for summary judgment. The court – having considered the memoranda filed by the parties and the arguments made in open court – has determined to grant United's motion, and deny the motions of the Defendants,

for the reasons set out in the memorandum of Decision filed with this order.

Accordingly, it is hereby ordered (1) that judgment is entered in favor of United, declaring the "Facilities Lease" at San Francisco International Airport, by and between United and the California Statewide Communities Development Authority, dated August 1, 1997, is not a lease for the purposes of assumption or rejection pursuant to § 365 of the Code, and (2) that the Defendants' cross-motions for summary judgment are denied.

Dated: March 30, 2004

/s/ Eugene R. Wedoff
Eugene R. Wedoff
United States Bankruptcy Judge

United States Court of Appeals
For the Seventh Circuit
Chicago, Illinois 60604

August 23, 2005

Before

Hon. WILLIAM J. BAUER, Circuit Judge

Hon. FRANK H. EASTERBROOK, Circuit Judge

Hon. DANIEL A. MANION, Circuit Judge

UNITED AIRLINES, INC., *Plaintiff-Appellant,* **Nos.** 04-4209, 04-4315 v. & 04-4321 HSBC BANK USA, N.A., as Trustee, and CALIFORNIA STATEWIDE COMMUNITIES DEVELOPMENT AUTHORITY, *Defendants-Appellees.*	Appeals from the United States District Court for the Northern District of Illinois, Eastern Division. Nos. 04 C 2836 & 2837 John W. Darrah, Judge.

Order

Defendants-appellees each filed a petition for rehearing and rehearing en banc on August 9, 2005. No judge in regular active service has requested a vote on the petitions for rehearing en banc,* and all of the judges on the panel have voted to deny rehearing. The petitions for rehearing are therefore DENIED.

* Judge Ripple took no part in the consideration of this matter.

11 U.S.C. § 365. Executory contracts and unexpired leases

* * *

(d)(3) The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period. This subsection shall not be deemed to affect the trustee's obligations under the provisions of subsection (b) or (f) of this section. Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

* * *

(m) For purposes of this section 365 and sections 541(b)(2) and 362(b)(10), leases of real property shall include any rental agreement to use real property.

* * *

No. 05-690

IN THE
Supreme Court of the United States

HSBC BANK USA, NATIONAL ASSOCIATION, AND CALIFORNIA STATEWIDE COMMUNITIES DEVELOPMENT AUTHORITY,

Petitioner,

v.

UNITED AIR LINES, INC.,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF IN OPPOSITION

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 29.6 of the Rules of this Court, Respondent United Air Lines, Inc. states that it is a wholly owned subsidiary of UAL Corporation, which is a publicly held company.

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INTRODUCTION

This case proves once again that litigants should be careful what they ask for. Petitioners argued strenuously below that whether a particular transaction qualifies as a "lease" within the meaning of 11 U.S.C. § 365 is determined by reference to state, not federal, law. The Seventh Circuit agreed with them, and therefore looked to California law to analyze the transaction at issue here. Unfortunately for petitioners, however, the Seventh Circuit disagreed with them as to the *substance* of California law, and concluded that the transaction at issue here was not a "lease" under California law. Petitioners now challenge that conclusion, but it goes without saying that this Court is not in the business of correcting alleged errors in the interpretation or application of state law.

Given that petitioners themselves argue that the meaning of a "lease" is governed by state law, their request "for the Court to articulate a clear, unambiguous rule as to what constitutes a 'lease' for purposes of the Bankruptcy Code," Pet. 23, is disingenuous at best. Where, as here, courts interpret the meaning of a federal statutory term by reference to state law, it is only to be expected that the term may have a different meaning in different States. Petitioners' suggestion of a circuit conflict on the meaning of the word "lease" in § 365 is thus baseless: any difference in the results of the various cases cited by petitioners can readily be explained by reference not only to their differing facts, but also to differing state laws. At the end of the day, petitioners' quarrel with the Seventh Circuit about California law does not remotely merit this Court's review.

COUNTERSTATEMENT OF THE CASE

A. Factual Background

Most of the Nation's commercial airport facilities are publicly owned, and commercial airlines thus must rent

space from public entities. Pet. 2. In 1973, respondent United Air Lines entered into an extended lease with the City and County of San Francisco governing United's use and occupancy of space at San Francisco International Airport ("SFO"). Pet. App. 4. There is no dispute that this is a true "lease" within the meaning of the Bankruptcy Code and, pursuant to § 365, United has continued to pay rent to the City and County of San Francisco even after filing for Chapter 11 bankruptcy.

At issue here is a separate 1997 transaction in which the California Statewide Communities Development Authority ("CSCDA") issued bonds on United's behalf to improve airport facilities. Pet. App. 4. The transaction was accomplished through a sublease and leaseback, in which United purported to sublease a 20-acre portion of its airport space to CSCDA for $1 for the entire term of the sublease and then lease back that space for a "rent" equal to interest on the bonds plus an administrative fee, which is paid to HSBC Bank, USA as trustee. *Id.* United is entitled to prepay under the leaseback and, if it does so, the sublease and leaseback terminate. Pet. App. 4-5. The leaseback requires United to pay the promised rent even if the facilities become obsolete, are damaged, or even destroyed. Pet. App. 5. At the end of the leaseback term, United will owe a "balloon" payment of $155 million. Pet. App. 4.

B. Procedural History

In December 2002, United filed for Chapter 11 bankruptcy in the Northern District of Illinois. Pet. App. 3. Several months later, United filed an adversary complaint seeking a declaratory judgment that the transaction between United and CSCDA was essentially a loan, not a true "lease" within the meaning of § 365 of the Bankruptcy Code, 11 U.S.C. § 365. Pet. App. 3. The distinction is critical: if the transaction were indeed a "lease," then United would be required to pay "rent" immediately to retain possession of the facilities; if, in

contrast, the transaction were a loan, then payment obligations would be subject to the automatic stay and discharge in bankruptcy. United and petitioners cross-moved for summary judgment.

The bankruptcy court (Wedoff, C.J.) held that the term "lease" in § 365 is limited to "true leases," and does not encompass transactions where the form of a lease is used but the substance is that of a loan. *See* Pet. App. 38-74. Applying this functional approach, the court concluded that the transaction between United and CSCDA was not a true "lease" within the meaning of § 365. The court based that conclusion on several considerations, including the fact that: (1) United had no right to terminate the leaseback before the redemption of the bonds; (2) the sublease and leaseback have the same term, coinciding with the redemption of bonds; and (3) the "rent" payable by United equals the debt service and administrative expenses connected to the bonds and has nothing to do with the "leased" property. Pet. App. 62-67. Whereas at the conclusion of a true lease, the leased property returns to the lessor with substantial value remaining, here the leasehold's "entire economic value is exhausted during the leaseback, and nothing reverts" to the purported lessor. Pet. App. 63. Accordingly, the bankruptcy court granted summary judgment to United.

The district court (Darrah, J.), reversed and granted summary judgment to petitioners. Pet. App. 19-33. The court concluded that, under California law, the transaction was a true lease. In reaching that conclusion, the district court relied substantially on *form*, rather than *substance*: because the transaction was captioned a "lease," it presumptively was a "lease" within the meaning of § 365 under California law. Pet. App. 28-29. The court also opined that, although the "rental" payments under the leaseback were exactly the amounts needed to pay the bonds and their administrative costs, the payments nonetheless constituted reasonable

compensation for the use and occupation of the subleased 20-acre portion of the airport facilities. Pet. App. 30.

A unanimous panel of the Seventh Circuit (Easterbrook, J., joined by Bauer and Manion, JJ.) reversed. The appellate court agreed with the district court that the matter was governed by California law, but rejected the district court's interpretation and application of that law. In particular, the Seventh Circuit held that the district court erroneously "thought that California allows form to control, [so that] because United and the CSCDA chose the form of a lease United is stuck with that characterization under § 365." Pet. App. 12. The Seventh Circuit rejected that formalistic approach, holding that "there can be no doubt that [California] uses a functional approach to separating leases from secured credit with respect to personal property" and "takes a similar approach for real property as a matter of common law." Pet. App. 13 (citing *Burr v. Capital Reserve Corp.*, 71 Cal. 2d 983 (1968); *Beeler v. Am. Trust Co.*, 24 Cal. 2d 1 (1944)).

Applying this functional approach, the Seventh Circuit concluded (as had the bankruptcy court) that the transaction between petitioners and United was not a true "lease." In reaching that conclusion, the appellate court noted that (1) the "rent" was not measured by the market value of the 20-acre parcel within the sublease-leaseback, but by the amount borrowed and that there was no connection between the rental value of the 20-acre parcel and United's financial obligation; (2) petitioners have no remaining interest at the end of the sublease-leaseback while the full underlying tenancy interest reverts to United at the end of the sublease-leaseback at no additional charge; (3) the "balloon" payment has no parallel in a true lease, while it is a common feature for loans; and (4) if United prepays, the lease and sublease terminate immediately—whereas in a true lease, prepayment would only secure the right to occupy the property for an additional period. Pet. App. 15-16. The

court further observed that petitioners could not cite "*any* case from *any* state deeming an arrangement of this kind to be a 'true lease.'" Pet. App. 16 (emphasis in original).

Petitioners sought rehearing and rehearing *en banc*, alleging the same inter- and intra-circuit conflicts asserted here. The petition was summarily denied. *See* Pet. App. 75.

REASON FOR DENYING THE WRIT

The Petition Challenges the Seventh Circuit's Interpretation and Application of State Law.

The petition is not worthy of this Court's review for the simple reason that it challenges the Seventh Circuit's interpretation of California law and the application of that law to the facts of this case. Needless to say, this Court does not sit to review "a question of state law," *Volt Info. Sciences, Inc. v. Board of Trs. of Leland Stanford Junior Univ.*, 489 U.S. 468, 474 (1989), *see also Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 60 n.3 (1995)—much less the application of state law to fact.

Petitioners insist, however, that the federal courts of appeals are divided on the question whether the term "lease" in 11 U.S.C. § 365 is defined by reference to state or federal law. *See* Pet. 12-13. According to petitioners, the Third and Seventh Circuits interpret the term by reference to state law, *see* Pet. 13 (citing, in addition to the decision below, *In re Pillowtex, Inc.*, 349 F.3d 711, 716 (3d Cir. 2003)), whereas the Second and Ninth Circuits interpret the term by reference to federal law, *see id.* (citing *In re PCH Assocs.*, 804 F.2d 193, 196-201 (2d Cir. 1986); *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 1182-86 (9th Cir. 1988)). There are two basic problems with this argument.

First, the alleged circuit conflict is illusory. As the Seventh Circuit explained below, although "some language in *PCH Associates* and *Moreggia* could be read

[to establish a federal rule]. ... we think it more likely that both courts were concerned with ... whether the word 'lease' in § 365 has a formal or functional scope ... than with ... what body of law identifies a 'true lease' under the functional approach." Pet. App. 12.

Second, petitioners are in no position to ask this Court to review the choice-of-law issue in any event, because they *prevailed* on that issue below. Petitioners asked the Seventh Circuit to hold that the interpretation of § 365 is governed by state, not federal, law, and that is exactly what the Seventh Circuit did. *See id.* Petitioners thus lost below *notwithstanding*—not *because of*—the Seventh Circuit's resolution of the choice-of-law issue. Accordingly, the issue has essentially fallen out of the case, because petitioners are not entitled to relief *regardless* of how that issue is resolved. To the extent they are asking this Court to resolve an alleged circuit conflict on that issue, they are asking for an advisory opinion.

The heart of the petition, thus, is petitioners' argument that a concededly "distinguished panel" of the Seventh Circuit, Pet. 11, misinterpreted and misapplied governing California law. In particular, petitioners complain that the panel "took it upon itself to rewrite and recharacterize a contract in a manner that conflicts with the original intent of the sophisticated contracting parties." Pet. 7. But whether the panel correctly decided that California law would characterize the particular transaction at issue here as a loan rather than a lease presents no "important question of federal law," much less a question on which the lower courts are "in conflict." S. Ct. R. 10.

In any event, the Seventh Circuit's interpretation and application of California law here are eminently sound. After "examin[ing] California's statute books and the decisions of its judiciary," the court concluded that California does not treat leases in a "mechanical fashion,"

and would treat the particular transaction at issue here as a loan rather than a lease. Pet. App. 13-15 (discussing, *inter alia*, *Burr* and *Beeler*).

Petitioners challenge that conclusion by arguing that, under California law, the only "leases" that can be characterized as loans are those where "the debtor actually owned the 'leased' property." Pet. 12. Tellingly, however, petitioners cite *no* California law in support of that argument. Indeed, petitioners make no effort whatsoever to respond to the Seventh Circuit's exhaustive analysis of California law, *see* Pet. App. 13-15, and the petition cites a grand total of *two* California cases.

Because petitioners contend—and the Seventh Circuit held—that the meaning of a "lease" under § 365 is determined by reference to state law, their further argument that "this case highlights the need for the Court to articulate a clear, unambiguous rule as to what constitutes a 'lease' for purposes of the Bankruptcy Code," is, to say the least, puzzling. Pet. 23; *see also id.* at 15 (complaining that, "[a]s things now stand, there is no 'uniform treatment' of leases among the circuits."). After all, if federal courts must look to *state* law to determine whether a transaction is a "lease" under § 365, then this Court cannot articulate a platonic federal rule "as to what constitutes a 'lease' for purposes of the Bankruptcy Code." Pet. 23.

Indeed, contrary to petitioners' assertion that the Seventh Circuit "created a new legal test," Pet. 7, and "minted a brand new doctrine," *id.* at 10, for distinguishing a true lease from a loan, petitioners themselves are the ones seeking to break new legal ground here. Every appellate court to consider this issue has followed a functional, rather than a formalistic, approach. *See, e.g.*, *Pillowtex*, 349 F.3d at 719 (looking to "the *economic reality* of the transaction," and concluding, "based on the particular facts of the case," that the transaction at issue there was not governed by its label)